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Financial Crimes Enforcement Network: Anti-Money Laundering Program and Suspicious Activity Report Filing Requirements for Registered Investment Advisers

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On August 25, 2015, the US Financial Crimes Enforcement Network ("FinCEN"), the bureau of the Department of the Treasury with principal responsibility for implementing anti-money laundering rules and regulations, issued a notice of proposed rulemaking aimed to prescribe minimum standards for anti-money laundering programs ("AML") for investment advisers registered, or required to be registered, with the US Securities and Exchange Commission ("SEC") and to require such investment advisers to report suspicious activity to FinCEN pursuant to the Bank Secrecy Act ("BSA").[1] Financial institutions other than investment advisers are already subject to BSA and self-regulatory organization rules requiring anti-money laundering programs.[2]

[1] The BSA is codified at 12 USC. 1829b, 12 USC. 1951–1959, 31 USC. 5311–5314 and 5316–5332 and notes thereto, with implementing regulations at 31 CFR Chapter X. *See* 31 CFR 1010.100(e).

[2] For more information regarding the anti-money laundering program requirements of broker-dealers and other financial institutions, please *see* "*New Customer Identification Procedure Rules for Brokers and Dealers Take Effect*," available at: http://www.shearman.com/en/newsinsights/publications/2003/10/new-customer-identification-procedure-rules-for-brokers-and-dealers-take-effect, and *see also* "*Treasury Department Publishes Final Rules Implementing Section 312 of the Patriot Act Relating to Foreign Correspondent Accounts and Private Banking Accounts*," available at

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I. Introduction and Executive Summary

Defined loosely, money laundering is the processing of criminal proceeds through the financial system to disguise their illegal origin or the ownership or control of the assets or promoting an illegal activity with illicit or legal source funds. Regulations to impose AML safeguards have been a work in progress for quite some time as FinCEN previously proposed two complementary rules in 2002 and 2003 intended to address such concerns, but decided to withdraw the proposals in 2008 after undergoing a re-evaluation of its regulatory framework.[3]

Since the proposals were withdrawn, there have been significant changes in the regulatory structure for investment advisers with the passage of the Dodd-Frank Act. In order to harmonize the now-withdrawn proposals with the post Dodd-Frank regulatory landscape, FinCEN is proposing the following three changes: (1) including investment advisers within the general definition of "financial institution" in the regulations implementing the BSA and adding a definition of investment adviser; (2) requiring investment advisers to establish AML programs; and (3) requiring investment advisers to report suspicious activity.

In general, the proposal will:

- Define the term "financial institution," as used throughout BSA regulations, to include investment advisers;
- Require investment advisers to implement anti-money laundering programs, including the (a) establishment of anti-money laundering policies and procedures, (b) independent testing of those policies and procedures, (c) nomination of an anti-money laundering compliance officer and (d) training of personnel; and,
- Require investment advisers to engage in suspicious activity reporting.

Each of these components is described below. FinCEN is soliciting comments on its rulemaking proposal. Comments are due on or before November 2, 2015.

II. Summary of Proposal

2.1 Who is an "Investment Adviser" for the Purposes of the Proposal?

In the rules being proposed, FinCEN is limiting the scope of the investment adviser definition to those advisers that are registered or required to be registered with the SEC.

http://www.shearman.com/en/newsinsights/publications/2006/02/antimoney-laundering-regulations-for-brokerdealers.

[3] *See Withdrawal of the Notice of Proposed Rulemaking; Anti-Money Laundering Programs for Unregistered Investment Companies*, 73 FR 65569 (Nov. 4, 2008); and *Withdrawal of the Notice of Proposed Rulemaking* ;and *Anti-Money Laundering Programs for Investment Advisers*, 73 FR 65568 (Nov. 4, 2008)

The proposed definition would include both primary advisers and subadvisers.[4] Generally, an investment adviser's assets under management (and level of U.S. contacts in the case of a foreign adviser) determine whether an investment adviser is required to register with the SEC.[5] An investment adviser typically falls into one of three categories based on its regulatory assets under management ("RAUM"),[6] *i.e.*, a large, mid-sized, or small adviser. Unless an exemption from SEC registration is available, a large adviser that has $100 million or more in in RAUM, would be included in the proposed definition.

FinCEN notes that large advisers would comprise the majority of investment advisers that are included in the definition of investment adviser for purposes of the rules being proposed. Mid-sized advisers with $25 million or more but less than $100 million, and small advisers with less than $25 million in RAUM are generally prohibited from registering with the SEC and therefore are excluded from the proposed definition, unless an exemption from the prohibition on SEC registration is available. However, FinCEN recognizes that investment advisers that are at risk for abuse by money launderers and other illicit actors may not be limited to advisers that are registered, or required to be registered, with the SEC. Therefore, the regulator claims it may consider future rulemakings to expand the application of the BSA to include investment advisers that are not required to be registered with the SEC.

The proposed definition may include, among others, the following types of advisers:

- dually-registered investment advisers and advisers that are affiliated with, or subsidiaries of, entities required to establish AML programs;
- certain foreign investment advisers;
- investment advisers to registered investment companies;
- financial planners;
- pension consultants; and
- entities that provide only securities newsletters and/or research reports.

[4] In the investment advisory industry, an adviser may act as the "primary adviser" or a "subadviser." The Advisers Act does not distinguish between advisers and subadvisers; all are "investment advisers." *See Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign Private Advisers,* Investment Advisers Act Release No. 3222 (June 22, 2011) [76 FR 39646 (July 6, 2011)], at note 504 and accompanying text. Generally, the primary adviser contracts directly with the client and a subadviser has contractual privity with the primary adviser. With respect to such a shared client, an advisory contract may grant the primary adviser the discretionary authority to retain and dismiss a subadviser. Other advisory contracts may only permit the primary adviser to recommend a subadviser to such a client—the client retains the authority to hire or dismiss a subadviser.

[5] *See Rules Implementing Amendments to the Investment Advisers Act of 1940* at 42955.

[6] Registration requirements detailed by Form ADV and Form PF, require private fund managers to make a yearly (or sometimes more frequent) calculation of their regulatory assets under management ("RAUM"). RAUM serves as a total tally of the assets over which the fund manager provides investment advice, calculated using a method proscribed by the SEC. The procedure for determining RAUM is described in the instructions for Form ADV (http://www.sec.gov/about/forms/formadv-instructions.pdf). *See also Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign Private Advisers.*

2.2 Defining an Investment Adviser as a "Financial Institution"

FinCEN is proposing to include investment advisers registered with the SEC within the general definition of "financial institution" in the regulations implementing the BSA. Defining investment advisers as a "financial institution" would require investment advisers to comply with all BSA regulatory requirements generally applicable to financial institutions, including Currency Transaction Report ("CTR") filing requirements, and the recordkeeping, transmittal of records, and retention requirements for the transmittal of funds under the Recordkeeping and Travel Rules (defined below) and other related recordkeeping requirements.

2.2.1. Investment Advisers' Obligation to File CTRs Replaces Obligation to File Form 8300

Under FinCEN's regulations that apply to a broad range of commercial activity, investment advisers are currently required to file reports on Form 8300 for the receipt of more than $10,000 in cash and negotiable instruments.[7] The rules being proposed would replace this requirement with a requirement that investment advisers file CTRs.[8] An investment adviser would file a CTR for a transaction involving a transfer of more than $10,000 in currency by, through or to the investment adviser.[9] The threshold applies to transactions conducted during a single business day.[10] A financial institution must treat multiple transactions as a single transaction if the financial institution has knowledge that the transactions are conducted by or on behalf of the same person.

Because investment advisers would no longer be required to file Form 8300s, investment advisers would be freed from having to report applicable transactions involving certain negotiable instruments reportable on Form 8300 but not the

[7] 31 CFR 1010.330(a)(1)(i). "Cash" and "negotiable instruments" include cashier's checks, bank drafts, traveler's checks, and money orders in face amounts of $10,000 or less, if the instrument is received in a "designated reporting transaction." 31 CFR 1010.330(c)(1)(ii)(A). A "designated reporting transaction" is defined as the retail sale of a consumer durable, collectible or travel or entertainment activity. 31 CFR 1010.330(c)(2). In addition, an investment adviser would need to treat the instruments as currency if the adviser knows that a customer is using the instruments to avoid the reporting of a transaction on Form 8300. 31 CFR 1010.330(c)(1)(ii)(B).

[8] *See* 31 CFR 1010.330(a) (stating that section 1010.330 [the BSA provision requiring the filing of the Form 8300] "does not apply to amounts received in a transaction reported under 31 USC. 5313 and 31 CFR 1010.311.") To the extent an investment adviser conducts transactions other than in currency (as defined in section 1010.100(m) for purposes of the CTR requirement), it would be exempt from reporting such transactions because the Form 8300 requirement does not apply.

[9] *See* 31 CFR 1010.311 and 31 CFR 1010.100(m) (currency is defined as the coin and paper of the United States or of any other country that is designated as legal tender and that circulates and is customarily used as a medium of exchange in a foreign country).

[10] *See* 31 CFR 1010.313(b). Financial institutions must file a CTR for a transaction or related transactions for each deposit, withdrawal, exchange of currency or other payment or transfer, by, through or to such financial institution which involves a transaction in currency of more than $10,000 during any one business day. Compare to the threshold requirement for the Form 8300 defining any transactions conducted between a payer (or its agent) and the recipient in a 24-hour period as related transactions. Transactions are considered related even if they occur over a period of more than 24 hours if the recipient knows, or has reason to know, that each transaction is one of a series of connected transactions. *See* 31 CFR 1010.330(b)(3).

CTR when the investment adviser suspects that the monetary instruments are being used to avoid the Form 8300 that is being filed.[11]

2.2.2 The Recordkeeping and Travel Rules and Other Related Recordkeeping Requirements

Under the applicable books and records regulations, and the so-called "Travel Rule,"[12] financial institutions must create and retain records for transmittals of funds, and ensure that certain information pertaining to the transmittal of funds "travel" with the transmittal to the next financial institution in the payment chain.[13] These rules apply to transmittals of funds that equal or exceed $3,000. It should be noted that this requirement may be something that is not currently recorded by investment advisers.

A "transmittal of funds" includes funds transfers processed by banks, as well as similar payments where one or more of the financial institutions processing the payment (*e.g.*, the transmittor's financial institution, an intermediary financial institution or the recipient's financial institution) is not a bank. When a financial institution accepts and processes a payment sent by or to its customer, then the financial institution would be the "transmittor's financial institution" or the "recipient's financial institution," respectively. The Recordkeeping and Travel Rules require the transmittor's financial institution to obtain and retain the name, address and other information about the transmittor and the transaction. The rules also require the recipient's financial institution (and in certain instances, the transmittor's financial institution) to obtain or retain identifying information on the recipient.

Under the proposed rule, investment advisers would fall within an existing exception that is designed to exclude from these requirements' coverage funds transfers or transmittals of funds in which certain categories of financial institutions are the transmittor, originator, recipient, or beneficiary. Finally, with respect to transactions in excess of $10,000, the proposed amendment would subject investment advisers to requirements to create and retain records for extensions of credit and cross-border transfers of currency, monetary instruments, checks, investment securities, and credit.

2.3 Required Anti-Money Laundering Programs for Investment Adviser

At a minimum, an anti-money laundering program will require investment advisers to: (a) develop internal policies, procedures and controls; (b) designate an anti-money laundering compliance officer; (c) implement an on-going employee training program; and (d) conduct an independent audit function to test the program.

[11] In determining whether to file a Form 8300, an investment adviser currently may need to treat instruments as currency if the adviser knows that a customer is using the instruments to avoid the reporting of a transaction on Form 8300. *See* 1010.330(c)(1)(ii)(B).

[12] *See* 31 CFR 1010.410 and 1010.430. The recordkeeping, transmittal of records and retention requirements for the transmittal of funds for non-bank financial institutions under 31 CFR 1010.410 are often referred to as the "Recordkeeping and Travel Rules." *See* infra Section IV.C.2. The rule requires all financial institutions to pass on certain information to the next financial institution, in certain funds transmittals involving more than one financial institution.

[13] *See* 31 CFR 1020.410(a) and 1010.410(f). Financial institutions are also required to retain records for five years. *See* 31 CFR 1010.430(d).

Some investment advisers have already implemented AML programs voluntarily, in some cases in order to take advantage of a SEC No-Action letter permitting securities broker-dealers to rely on registered investment advisers in connection with some or all aspects of broker-dealers' customer identification program ("CIP") obligations.[14]

2.3.1. Overview of AML Program Requirement

The proposed rule would require each investment adviser to develop and implement a written AML program reasonably designed to prevent the investment adviser from being used to facilitate money laundering and to achieve and monitor compliance with the applicable provisions of the BSA and FinCEN's implementing regulations. The AML program must be approved in writing by its board of directors or trustees, or if the investment adviser does not have a board, by its sole proprietor, general partner, trustee or other persons that have functions similar to a board of directors. Each investment adviser would also be required to make its AML program available to FinCEN or the SEC upon request. The AML program requirement is not a one-size-fits-all requirement but rather is risk-based. The risk-based approach of the proposed rule is 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.[15]

a. *Establish and Implement Policies, Procedures and Internal Controls*

Generally, an investment adviser must review, among other things, the types of advisory services it provides and the nature of the clients it advises to identify its vulnerabilities to money laundering and terrorist financing activities, and the adviser's policies, procedures and internal controls must be developed based on this review. An investment adviser's AML program may encompass many types of advisory clients, including individuals, institutions, registered investment companies and other pooled vehicles, including private funds and other unregistered pools, regardless of whether the investment adviser is acting as the primary adviser or a subadviser.

[14] Under the SEC No-Action letter re-issued in consultation with FinCEN on January 9, 2015, a broker-dealer in securities is permitted to rely on a registered investment adviser in connection with all or part of its CIP obligations with regard to shared clients as if the investment adviser were subject already to an AML program rule, provided the other provisions of CIP reliance are met. Securities and Exchange Commission, Division of Trading and Markets, *Request for No-Action Relief Under Broker-Dealer Customer Identification Rule* (*31 C.F R. 1023.220*) (Jan. 9, 2015) *available at* http://www.sec.gov/divisions/marketreg/mr-noaction/2015/sifma-010915-17a8.pdf. *See also* 31 CFR 1023.220(a)(6) (CIP rule permitting a financial institution to rely on another financial institution to perform all or part of its obligations to verify the identity of its customers as required by 31 USC. 5318(h)). For more information regarding broker-dealer CIP rules, please see https://www.sec.gov/rules/final/34-47752.htm.

[15] The legislative history of the BSA reflects that Congress intended that each financial institution should have the flexibility to tailor its program to fit its business, taking into account factors such as size, location, activities and risks or vulnerabilities to money laundering, so long as the program meets the four minimum statutory requirements. This flexibility is designed to ensure that all firms, from the largest to the smallest, have in place policies and procedures appropriate to monitor for money laundering. *See* USA PATRIOT Act of 2001: Consideration of H.R. 3162 Before the Senate, 147 Cong. Rec. S10990–02 (Oct. 25, 2001) (statement of Sen. Sarbanes); Financial Anti-Terrorism Act of 2001: Consideration Under Suspension of Rules of H.R. 3004 Before the House of Representatives, 147 Cong. Rec. H6938–39 (Oct. 17, 2001) (statement of Rep. Kelly) (provisions of the Financial Anti-Terrorism Act of 2001 were incorporated as Title III in the Act).

b. *Provide for Independent Testing for Compliance to be Conducted by Company Personnel or by a Qualified Outside Party*

The proposed rule requires an investment adviser provide for independent testing of the program on a periodic basis to ensure that it complies with the requirements of the rule and that the program functions as designed. Employees of either the investment adviser, its affiliates or unaffiliated service providers may conduct the independent testing, provided those same employees are not involved in the operation and oversight of the program. The frequency of the independent testing will depend upon the investment adviser's assessment of the risks posed.

c. *Designate a Person or Persons Responsible for Implementing and Monitoring the Operations and Internal Controls of the Program*

The person or persons should be knowledgeable and competent regarding FinCEN's regulatory requirements and the adviser's money laundering risks, and should have full responsibility and authority to develop and enforce appropriate policies and procedures to address those risks. Whether the compliance officer is dedicated full time to BSA compliance would depend on the size and type of advisory services the adviser provides and the clients it serves. A person designated as a compliance officer should be an officer of the investment adviser.

d. *Provide Ongoing Training for Appropriate Persons*

The proposed rule would require that employees of an investment adviser (and of any agent or third-party service provider) must be trained in BSA requirements relevant to their functions and in recognizing possible signs of money laundering that could arise in the course of their duties. Such training may be conducted by outside or inhouse seminars, and may include computer-based training. The nature, scope and frequency of the investment adviser's training program would be determined by the responsibilities of the employees and the extent to which their functions bring them in contact with BSA requirements or possible money laundering activity.

2.3.2 Applicability Date

FinCEN is proposing that an investment adviser must develop and implement an AML program that complies with the applicable requirements on or before six months from the effective date of the regulation.

2.4 Reports of Suspicious Transactions

In 1992, the Annunzio-Wylie Act authorized the Secretary to require financial institutions to report suspicious transactions.[16] FinCEN has issued rules under this authority requiring banks, casinos, money services businesses, broker-dealers in securities, mutual funds, insurance companies, futures commission merchants and introducing brokers in commodities, among others, to report suspicious activity. SAR activity and considerations regarding SAR filing are well-known to these financial institutions.

[16] 31 USC. 5318(g) was added to the BSA by section 1517 of the Annunzio-Wylie Anti-Money Laundering Act, Title XV of Pub. L. 102-550 (October 28,1992); it was expanded by section 403 of the Money Laundering Suppression Act of 1994 (the Money Laundering Suppression Act), Title IV of the Riegle Community Development and Regulatory Improvement Act of 1994, Public Law 103–325, to require designation of a single government recipient for reports of suspicious transactions. As amended by the USA PATRIOT Act, subsection (g)(1) states generally that "the Secretary may require any financial institution, and any director, officer, employee or agent of any financial institution, to report any suspicious transaction relevant to a possible violation of law or regulation."

The rule, as proposed, does not permit investment advisers to share suspicious activity reports ("SARs") within their corporate organizational structures in the absence of further guidance. FinCEN understands that investment advisers may find it necessary to share SARs within their organizational structures to fulfill reporting obligations under the BSA, and to facilitate more effective enterprise wide BSA compliance. FinCEN is interested in hearing from investment advisers on this specific issue and is mindful that guidance on this topic may need to be issued in a timely manner following the issuance of any final rule.

2.4.1. Reports by Registered Investment Advisers of Suspicious Transactions

The proposed rule sets forth the obligation of investment advisers 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. The $5,000 minimum amount in this proposed rule is consistent with the SAR filing requirements for most other financial institutions that are subject to a SAR reporting requirement under FinCEN's rules implementing the BSA. A transaction is reportable under this proposed rule regardless of whether the transaction involves currency.

The proposal specifies that an investment adviser is 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): (i) involves funds derived from illegal activity or is intended or conducted to hide or disguise funds or assets derived from illegal activity; (ii) is designed, whether through structuring or other means, to evade the requirements of the BSA; (iii) 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 (iv) involves the use of the investment adviser to facilitate criminal activity.[17]

A determination as to whether a SAR must be filed should be based on all the facts and circumstances relating to the transaction and the client in question. Although there is no definitive list, some red flags include the following: (i) a client exhibits an unusual concern regarding the adviser's compliance with government reporting requirements or is reluctant or refuses to reveal any information concerning business activities, or furnishes unusual or suspicious identification or business documents; (ii) a client appears to be acting as the agent for another entity but declines, evades or is reluctant to provide any information in response to questions about that entity; (iii) a client's account has a pattern of inexplicable and unusual withdrawals, contrary to the client's stated investment objectives; (iv) a client requests that a transaction be processed in such a manner as to avoid the adviser's normal documentation requirements; or (v) a client exhibits a total lack of concern regarding performance returns or risk.[18]

The proposal also provides that the obligation to identify and report a suspicious transaction rests with the investment adviser involved in the transaction. However, where more than one investment adviser, or another financial institution with a separate suspicious activity reporting obligation, is involved in the same transaction, only one report is required to be filed.

[17] The fourth category of reportable transactions has been added to the suspicious activity reporting rules promulgated since the passage of the USA PATRIOT Act to make it clear that the requirement to report suspicious activity encompasses the reporting of transactions involving fraud and those in which legally derived funds are used for criminal activity, such as the financing of terrorism.

[18] The Proposed Unregistered Investment Companies Rule also provided examples of suspicious transactions that could indicate potential money laundering in an unregistered investment company. *See Anti-Money Laundering Programs for Unregistered Investment Companies* at 60620.

2.4.2. Filing and Notification Procedures

Within 30 days after an investment adviser becomes aware of a suspicious transaction, the adviser must report the transaction by completing and filing a SAR with FinCEN. Supporting documentation relating to each SAR is to be collected and maintained separately by the investment adviser and made available upon request to FinCEN and other appropriate regulatory authorities. For situations requiring immediate attention, such as suspected terrorist financing or ongoing money laundering schemes, investment advisers are required to notify immediately by telephone the appropriate law enforcement authority in addition to filing a timely SAR.

2.4.3. Retention of Records

Investment advisers must maintain copies of filed SARs and the underlying related documentation for a period of five years from the date of filing.

2.4.4. Compliance Date

The new suspicious activity reporting requirement applies to transactions initiated after the implementation of an AML program required by the proposal. However, FinCEN encourages investment advisers to begin filing SARs as soon as practicable on a voluntary basis upon the issuance of the final rule. Investment advisers may conduct some of their operations through agents or third-party service providers, which may or may not be affiliated with the investment adviser, such as broker-dealers in securities, custodians, administrators or transfer agents. Just as investment advisers are permitted to delegate the implementation and operation aspects of their AML programs to such service providers, an investment adviser is permitted to delegate its suspicious activity reporting requirements. However, if an investment adviser delegates such responsibility to an agent or a third-party service provider, the adviser remains responsible for its compliance with the requirement to report suspicious activity, including the requirement to maintain SAR confidentiality.

III. Absence of CIP Requirements

In this rulemaking, FinCEN is not proposing a customer identification program requirement or including within the AML program requirements provisions recently proposed with respect to AML program requirements for other financial institutions.[19] FinCEN anticipates addressing both of these issues with respect to investment advisers, as well as other issues, such as the potential application of regulatory requirements consistent with Sections 311, 312, 313 and 319(b) of the USA PATRIOT Act,[20] in subsequent rulemakings, with the issue of customer identification program requirements anticipated to be addressed via a joint rulemaking effort with the SEC.

It should be noted that for other financial institutions, the CIP is one of the cornerstones of the anti-money laundering program. However, the absence of a CIP requirement is somewhat hollow, because as noted above, many investment advisers already have CIP procedures, and additionally, many financial institutions will not do business with an investment adviser that does not conduct CIP.

[19] Customer Due Diligence Requirements for Financial Institutions, 79 FR 45151 (Aug. 4, 2014).

[20] Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 ("USA PATRIOT Act") (Pub. L. No. 107–56).

IV. Conclusion

FinCEN is seeking input on various details relating to the proposal, so it is still unclear how the final rule will take shape. The timing of the proposal will be directly related to the volume of response. We will continue to track and report on the rulemaking as it progresses.

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