

SEC and FinCEN's Proposed AML Rule Could Increase Compliance Burden on Investment Advisers

RIAs and ERAs may soon be required to implement procedures to verify their clients' identities.

On May 13, 2024, the Securities and Exchange Commission (SEC) and the US Department of the Treasury's Financial Crimes Enforcement Network (FinCEN) jointly published a proposed rule (the Proposal) that, if adopted, would subject registered investment advisers (RIAs) and exempt reporting advisers (ERAs) to new anti-money laundering and countering the financing of terrorism (AML/CFT) compliance obligations.

Generally, the Proposal would require an investment adviser to establish, document, and maintain a written customer identification program (CIP) appropriate for its size and business. The CIP must be a part of the investment adviser's AML/CFT compliance program. If the Proposal is finalized, private fund sponsors will need to (1) update subscription documentation to ensure relevant identification documentation and information is collected; and (2) update compliance policies and procedures to include requirements of the CIP.

The Proposal supplements a separate FinCEN proposal published in February 2024 that would further subject certain investment advisers to comprehensive AML program requirements. In light of the interrelated proposed rulemakings, industry groups are encouraging the SEC and the Department of the Treasury to develop a more tailored approach to address specific risks and avoid unnecessary regulatory burdens, particularly with respect to emerging and smaller advisers. Industry groups are also advocating for an additional opportunity for commenters to submit/supplement prior submissions in light of this new Proposal.

Covered Investment Advisers

The Proposal applies to two types of investment advisers:

- RIAs — investment advisers registered or required to register with the SEC under Section 203 of the Investment Advisers Act of 1940 (Advisers Act)
- ERAs — investment advisers exempt from SEC registration and that report to the SEC as exempt reporting advisers under Section 203(l) or 203(m) of the Advisers Act

Under the Proposal, the definition of an investment adviser would not apply to investment advisers exclusively registered at the state-level and non-US investment advisers that rely on the foreign private adviser exemption. However, non-US investment advisers that are registered with the SEC (or report to the SEC as an ERA) are included.

AML/CFT Program Requirements

The Proposal would require that all covered investment advisers implement a reasonably designed AML/CFT program addressing the covered investment adviser's advisory activities, except those activities related to mutual funds. In excluding mutual funds, the SEC noted that any CIP requirement imposed on an RIA to a mutual fund is already addressed by the existing CIP requirements imposed on the mutual fund itself.

At a minimum, covered investment advisers would be required to establish, document, and maintain written CIPs appropriate for their respective sizes and businesses, including risk-based procedures for verifying the identity of each customer to the extent reasonable and practicable, and within a reasonable time before or after the customer's account is opened.

A "customer" is defined in the Proposal as any person that opens a new account with the covered investment adviser. An "account" is defined in the Proposal as any contractual or other business relationship between a person and the covered investment adviser under which the covered investment adviser provides investment advisory services. Such proposed definition excludes any accounts the covered investment adviser acquired through any acquisition, merger, purchase of assets, or assumption of liabilities.

Each covered investment adviser's CIP would need to include risk-based procedures to verify the identity of each customer. While the procedures should be reasonably tailored to the specific covered investment adviser's relevant risks, size, location, and investor base, the Proposal would require that at minimum the CIP include procedures for:

- obtaining identifying information of each customer, including the customer's name, date of birth or date of formation if an entity, address, and identification number (e.g., taxpayer ID number, passport number, etc.);
- verifying such customer's identification, including procedures that set forth when documents and non-documentary methods will be used for such verification;
- determining under which circumstances, based on its risk assessment of a new account opened by a customer that is an entity, the investment adviser will obtain information about individuals with authority or control over such account to verify the customer's identity;
- responding to circumstances in which the covered investment adviser cannot form a reasonable belief that it knows the true identity of a customer; and
- determining whether a customer appears on any list of known or suspected terrorists or terrorist organizations.

Recordkeeping Requirements

The Proposal would also require that covered investment advisers' CIPs include procedures for making and maintaining a record of information obtained under such CIP. At a minimum, such required records would need to include:

- all identifying information about a customer obtained pursuant to the CIP (retained for five years after the date the account is closed);
- a description of any document that was relied on for verification purposes, noting the type of document, any identification number contained in the document, the place of issuance, and, if any, the date of issuance and expiration date (retained for five years after the record is made);
- a description of the methods and results of any measures undertaken to verify the identity of a customer (retained for five years after the record is made); and
- a description of the resolution of each substantive discrepancy discovered when verifying the identifying information obtained (retained for five years after the record is made).

Notice Requirements

The Proposal would additionally require that covered investment advisers' CIPs include procedures for providing customers with adequate notice that the covered investment adviser will be requesting information to verify customers' identities. Notice would need to be given in a manner reasonably designed to ensure that a prospective customer is able to view the notice, or is otherwise given notice, before opening an account.

Conclusion

If adopted, the Proposal would increase the compliance burden of covered investment advisers.

The Proposal will be open for comment for 60 days upon publication in the Federal Register. The Proposal indicates that, if adopted, covered investment advisers would need to develop and implement a CIP that complies with the requirements of such final rule within six months after the effective date of the final rule.

Latham & Watkins will continue to monitor and provide updates on details regarding the Proposal.

If you have questions about this Client Alert, please contact a member of our [Investment Funds Practice](#) or the Latham lawyer with whom you normally consult.

[Laura Ferrell](#)

laura.ferrell@lw.com
+1.312.876.7616
Chicago

[Aaron Gilbride](#)

aaron.gilbride@lw.com
+1.202.637.2264
Washington, D.C.

[Jamie Lynn Walter](#)

jamie.lynn.walter@lw.com
+1.202.637.2234
Washington, D.C.

[Jennifer Y. Tian](#)

jennifer.tian@lw.com
+1.312.777.7165
Chicago

You Might Also Be Interested In

[Key Takeaways From SEC's First "Off-Channel Communications" Settlement With Stand-Alone Registered Investment Adviser](#)

[SEC Announces First-Ever Enforcement Actions for "AI Washing"](#)

[Private Capital Insights — January 2024](#)

Client Alert is published by Latham & Watkins as a news reporting service to clients and other friends. The information contained in this publication should not be construed as legal advice. Should further analysis or explanation of the subject matter be required, please contact the lawyer with whom you normally consult. The invitation to contact is not a solicitation for legal work under the laws of any jurisdiction in which Latham lawyers are not authorized to practice. A complete list of Latham's Client Alerts can be found at www.lw.com. If you wish to update your contact details or customize the information you receive from Latham, [visit our subscriber page](#).