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FinCEN Proposes New Investment Adviser AML Rule

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The material set forth below was developed before the 2024 and 2025 district court injunctions regarding the CTA (which were subsequently stayed and continue to be litigated). As a result, the material set forth below, including filing deadlines, may not be current. Please consult FinCEN's website for the latest filing due dates and other information regarding the CTA and its requirements.

Introduction

On February 1/3, the Financial Crimes Enforcement Network (FinCEN) proposed a new rule (the Proposed Rule), that, if adopted, would add certain investment advisers to the definition of "financial institution" under the Bank Secrecy Act of 1970 (BSA) and require those advisers to:

- Establish Anti-Money Laundering/Countering the Financing of Terrorism (AML/CFT) programs, including risk-based procedures for conducting ongoing customer due diligence (CDD);
- Report suspicious activity to FinCEN by filing Suspicious Activity Reports (SARs) and Currency Transaction Reports (CTRs);
- Maintain records of originator and beneficiary information for certain transactions;
- Apply information-sharing provisions between and among FinCEN, law enforcement, agencies, and certain financial institutions; and
- Implement special due diligence requirements for correspondent and private banking accounts, and special measures under Section 311 of the USA PATRIOT Act.[1]

Unlike banks, mutual funds, and broker dealers, which are currently "financial institutions" under the BSA, investment advisers are not required to maintain AML/CFT programs or records under the BSA. Notably, the Proposed Rule would not permit advisers to exempt mutual funds that they advise from the proposed information sharing, special standards, prohibitions, and other requirements, which are discussed below.

Many larger advisers implement AML policies and procedures as a matter of best practice and comply with

Treasury's sanctions regulations,[2] but not all of those advisers are subject to regular examinations to test the adequacy of their programs.[3] FinCEN is hoping the Proposed Rule, if adopted, would close this gap and, among other things, help identify, prevent, and deter bad actors from using investment advisers to further illicit financial activity. If adopted as proposed, the rule would apply to both SEC registered investment advisers (RIAs) and SEC exempt reporting advisers (ERAs).[4]

Notably, FinCEN is proposing to delegate examination authority for this rule to the Securities and Exchange Commission (SEC) given the SEC's expertise in the regulation of investment advisers and experience in examining other financial institutions with respect to AML/CFT responsibilities. Both RIAs and ERAs would be subject to SEC examination for compliance with the final version of the Proposed Rule.

The Proposed Rule is the latest in a series of moves by state and federal regulators attempting to combat money laundering and illicit finance activities by increasing reporting requirements for certain entities.[5] FinCEN believes the Proposed Rule would also bring the investment adviser industry more in line with its counterparts in the U.S. financial sector and around the world. FinCEN is hoping the Proposed Rule also will improve the U.S. government's understanding of priority national security threats, including funds moving through the U.S. financial system that may be associated with Russian oligarchs and investment activity that may be tied to foreign-state efforts to invest in early-stage companies developing critical or emerging technologies with national security implications.

Déjà Vu? FinCEN's Third Attempt to Issue Investment Adviser AML/CFT Rule

The BSA authorizes the Secretary of the Treasury, to define a business or agency as a "financial institution" under the BSA if it engages in any activity determined by regulation "to be an activity which is similar to, related to, or a substitute for any activity" in which a "financial institution" as defined by the BSA is authorized to engage. The Proposed Rule is FinCEN's third attempt to define investment advisers as such. FinCEN first proposed rules in 2003, which were subsequently withdrawn in 2008.[6] Then, in 2015, FinCEN reproposed its rule, but it was never finalized. In March 2022, a group of six Senate committee chairs including Senator Mark Warner (D-VA), chair of the Senate Intelligence Committee, sent a letter to the Treasury Department urging the agency to take up its 2015 proposal.[7] In December 2022, the U.S. Senate also tried but failed to amend the statutory definition of "financial institutions" through the proposed ENABLERS Act.[8] According to the Proposed Rule release, FinCEN will withdraw its 2015 proposal and issued the new Proposed Rule to ensure that changes in the risk and factual context since 2015 are taken into account.

Key Requirements of the Proposed Rule

Implementation of an AML/CFT Program

The Proposed Rule would require advisers to establish an AML/CFT program that includes:

- **Internal Policies, Procedures, and Controls**: The adviser must develop and implement internal policies, procedures, and controls to prevent the investment adviser from being used for illicit finance activities and to comply with the Bank Secrecy Act and associated regulations.

- **Designation of Responsible Person**: The adviser must designate a qualified individual (or individuals) responsible for implementing and maintaining the day-to-day operation of the AML/CFT program.

- **Ongoing Training**: The adviser must provide ongoing training in AML/CFT requirements pertinent to their roles and in identifying potential indicators of money laundering, terrorist financing, and other illicit financial activities that may occur during their responsibilities.

- **Independent Compliance Testing**: The adviser must arrange for independent compliance testing to be conducted by a qualified third party or the investment adviser's personnel.

- **Ongoing Customer Due Diligence (CDD)**: The adviser must implement risk-based procedures for ongoing customer due diligence. This includes understanding the nature and purpose of customer relationships to develop a customer risk profile, conducting ongoing monitoring to identify and report suspicious transactions, and maintaining and updating customer information based on risk.[9]

In developing their programs, advisers would not be required to adopt a one-size-fits-all approach. The Proposed Rule would give advisers the flexibility to take a risk-based approach in designing their programs by tailoring them to the specific risks of the advisory services they provide and the customers they advise.[10] FinCEN contemplates that advisers would be able to build upon existing policies, procedures, and internal controls (or the processes undertaken to establish the same) to comply with the proposed AML/CFT requirements.

Suspicious Activity and Currency Transaction Reporting

Under the Proposed Rule, advisers would be required to file a SAR for any transaction that involves or aggregates to $5,000 or more and the financial institution knows, suspects, or has reason to suspect that the transaction:

- Involves funds derived from illegal activities or is intended or conducted to hide or disguise funds or assets derived from illegal activities;

- Is designed to evade the BSA's requirements; or

- Has no business or apparent lawful purpose or is not the type of transaction that the particular customer would normally be expected to engage in, and the financial institution knows of no reasonable explanation for the transaction after examining the available facts.

Advisers will also be required to file a SAR if:

- The adviser suspects or has reason to suspect that an insider (such as an employee, director, officer, or controlling shareholder) is involved in a suspicious transaction, regardless of the amount involved in the transaction; or

- The adviser suspects or has reason to suspect that a suspicious transaction involves potential money

laundering or violations of the BSA that require immediate attention, such as ongoing money laundering schemes.

The reporting should occur within 30 days from the initial detection of the suspicious activity. Noncompliance with this rule could lead to penalties imposed by FinCEN under the BSA. The Proposed Rule also mandates the retention of records related to SARs reporting and ensures confidentiality for firms reporting a SAR, attempting to safeguard them from liability. The proposal exempts mutual fund advisers and nonadvisory services like private equity fund advisers operating as part of a management team at a portfolio company.

To satisfy their existing obligations to report currency transactions over $10,000 in cash and negotiable instruments, the Proposed Rule would require advisers to use the Currency Transaction Report (CTR) instead of the joint FinCEN/Internal Revenue Service Form 8300 (Form 8300).[11]

Recordkeeping and Travel Rule

Under the Proposed Rule, advisers would be required to comply with the Record Keeping and Travel Rule regulations of the BSA. This would mean advisers must:

- Retain records for funds transfers and transmittals of funds that equal or exceed $3,000;
- Ensure the records include the name and address of the transmitter and recipient, the amount of the transaction, the execution date, and any payment instructions received from the transmitter;
- Retain these records for five years.
- Include certain information in transmittal orders, such as the name of the transmitter and recipient, their account numbers, and their addresses; and
- Ensure that the information “travels” with the transmittal order through each phase of the payment chain.

Information-Sharing

FinCEN’s regulations under Section 314(a) of the USA PATRIOT Act enable law enforcement agencies, through FinCEN, to request information from financial institutions to locate accounts and transactions of persons that may be involved in terrorism or money laundering. The Proposed Rule would authorize law to request from advisers, where there is reasonable suspicion and credible evidence, potential lead information that might otherwise never be uncovered. Upon such a request from FinCEN, the adviser would be required to “expeditiously search its records for specified information to determine whether it maintains or has maintained any account for, or has engaged in any transaction with, an individual, entity, or organization named in FinCEN’s request.” An investment adviser would then be required to report any such identified information to FinCEN. Section 314(b) of the USA PATRIOT Act provides financial institutions with the ability to voluntarily share information regarding parties suspected of possible terrorist or money laundering activities with another financial institution upon notice to the

Treasury under a safe harbor that offers protections from liability.

Special Standards of Diligence; Prohibitions; and Special Measures

The Proposed Rule, if adopted, would subject advisers to special due diligence standards consistent with the special due diligence standards applied to similarly situated financial institutions under the BSA. Section 312 of the USA PATRIOT Act establishes special due diligence requirements for private banking and correspondent bank accounts involving foreign persons. Specifically, advisers would be required to maintain due diligence programs for correspondent accounts for foreign financial institutions and for private banking accounts that include policies, procedures, and controls that are reasonably designed to detect and report any known or suspected money laundering or suspicious activity conducted through or involving any such correspondent or private banking accounts. In addition to meeting required minimum standards for such due diligence programs, advisers would be required to have procedures for enhanced due diligence for correspondent accounts for foreign banks and private banking accounts for senior foreign political figures.

The Proposed Rule would also require advisers to comply with special measures provisions of Section 311 of the USA PATRIOT Act and Section 9714(a) of the Combatting Russian Money Laundering Act. Section 311 requires U.S. financial institutions to implement certain "special measures" if the Secretary finds that reasonable grounds exist to conclude that a foreign jurisdiction, institution, class of transaction, or type of account is a "primary money laundering concern." Special measures range from requiring additional due diligence, recordkeeping, and reporting concerning particular account transactions, to prohibiting the opening or maintenance of any correspondent or payable-through accounts. Section 9714(a) provides for similar special measures, but specifically in the context of Russian illicit finance.

Next Steps

The comment period for the Proposed Rule will remain open until 60 days after its publication in the Federal Register, which is April 15. If adopted, RIAs and ERAs would be required to comply with the Proposed Rule on or before 12 months from the final rule's effective date.

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[1] Pub. L. 107-56, section 312 (Oct. 26, 2011), codified as 31 U.S.C. 5318(i).

[2] All U.S. persons must comply with the regulations of Office of Foreign Assets Control (OFAC), including all U.S. citizens and permanent resident aliens regardless of where they are located, all persons and entities within the United States, and all U.S. incorporated entities and their foreign branches. OFAC is an office of the U.S. Treasury that administers and enforces economic and trade sanctions based on U.S. foreign policy and national security goals against entities such as targeted foreign countries, terrorists, international narcotics traffickers, and those engaged in activities related to the proliferation of weapons of mass destruction. OFAC regulations generally require blocking accounts and other property of specified countries, entities, and individuals; and prohibiting or rejecting unlicensed trade and financial transactions with specified countries, entities, and individuals. Many

advisers maintain policies prohibiting business dealings with countries, entities, and individuals specified on the OFAC lists of "Specially Designated Nationals, Blocked Persons or Sanctioned Countries," which are available at http://www.treas.gov/offices/enforcement/ofac/sdn/.

[3] Per rule 206(4)-7, investment advisers registered with the SEC must implement and maintain policies and procedures reasonably designed to prevent and detect violations of the Investment Advisers Act of 1940, as amended (Advisers Act). SEC-registered investment advisers must maintain books and records, including those regarding their compliance programs, which are subject to regular SEC exam.

[4] ERAs are investment advisers relying on exemptions from SEC registration under sections 203(l) and 203(m) of the Advisers Act and 17 CFR 275.203(l)-1 and 275.203(m)-1. While the Proposed Rule does not apply to State-registered investment advisers, FinCEN will continue to monitor their activity for indicia of money laundering, terrorist financing, or other illicit finance activities, and may action to mitigate any such activity.

[5] Earlier this year, FinCEN's Beneficial Ownership Information Reporting Requirements went into effect, implementing Section 6403 of the Corporate Transparency Act (CTA), see our client alert here. Also, New York State passed the New York LLC Transparency Act (NYLTA), which largely mirrors the CTA and requires nonexempt LLCs in New York to disclose beneficial owner information to the New York Department of State. For more information on the NYLTA, see our client alert here.

[6] FinCEN, Anti-Money Laundering Programs for Investment Advisers, 68 FR 23646 (May 5, 2003); FinCEN, Withdrawal of the Notice of Proposed Rulemaking; Anti-Money Laundering Programs for Unregistered Investment Companies, 73 FR 65569 (Nov. 4, 2008)

[7] See Letter dated March 30, 2022, to Hon. Janet Yellen, Secretary, U.S. Department of the Treasury, from Senators Jack Reed, Richard J. Durbin, Sherrod Brown, Ron Wyden, Robert Menendez and Mark R. Warner, available at: 4B993E920232BF5068BCA4EFA3A5F5C1.money-laundering.pdf (senate.gov).

[8] See H. R. 5525, 117th Congress (2021-2022) at https://www.congress.gov/bill/117th-congress/house-bill/5525/text.

[9] The proposed customer due diligence requirements incorporate two out of four core elements of the FinCEN rule titled "Customer Due Diligence Requirements for Financial Institutions," (81 Fed. Reg. 29397 (May 11, 2016) (the CDD Rule). FinCEN is not proposing to require advisers to identify and verify the identity of customers at this time (*i.e.*, a customer identification program (CIP) requirement), but according to the adopting release FinCEN anticipates addressing that requirement the future joint rulemaking with the SEC. FinCEN also is not proposing to require advisers to identify and verify the beneficial owners of legal entity customer accounts at this time because that requirement is predicated on the CIP requirement. According to the adopting release, FinCEN will not impose beneficial ownership identification and verification on advisers until the effective date of the expected revisions to the CDD Rule to bring it into conformance with the CTA. The CDD Rule must be revised for conformance no later than January 1, 2025.

[10] Since mutual funds are already defined as "financial institutions" under the BSA, the Proposed Rule would not require advisers to apply the AML/CFT program or SAR reporting requirements to mutual funds they advise.

However, FinCEN did not propose to permit advisers to exempt mutual funds that they advise from the proposed information sharing, special standards, prohibitions, and other requirements, which are discussed below.

[11] See FinCEN, Proposed Renewal: Renewal Without Change of the Bank Secrecy Act Reports of Transactions in Currency Regulations at 31 CFR 1010.310 Through 1010.314, 31 CFR 1021.311, and 31 CFR 1021.313, and FinCEN Report 112-Currency Transaction Report, 85 FR 29022 (July 13, 2020).

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