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Locke Lord QuickStudy: FUNDamentals: FinCEN [Re]Proposes Anti-Money Laundering Rules for Investment Advisers

FUNDamentals™ Series

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On February 13, 2024, the U.S. Department of the Treasury's Financial Crimes Enforcement Network ("FinCEN") proposed a new rule that would require federal investment advisers to add Bank Secrecy Act ("BSA") type anti-money laundering ("AML") and counter-terrorist financing ("CTF") compliance programs to their already extensive list of compliance requirements. The new rule as proposed would apply to all investment advisers that are (1) registered or required to register with the U.S. Securities and Exchange Commission (the "SEC") and (2) investment advisers that report to the SEC as Exempt Reporting Advisers (together, "Investment Advisers"), in each case pursuant to the Investment Advisers Act of 1940, as amended and the rules thereunder. FinCEN previously proposed similar rules in 2002, 2003 and 2015, but they were never adopted.

FinCEN has based this rulemaking in part on its 2024 Investment Adviser Risk Assessment, which identified that investment advisers were vulnerable to money laundering, terrorist financing and other illicit activity exploitation. In the proposal, FinCEN asserted its authority, pursuant to Chapter X of title 31 of the Code of Federal Regulations, to implement the new rule, which includes amending the definition of "financial institution" therein to include "investment advisers" as specified in 31 CFR 1010.100(t).

Most investment advisers, other than those that are also licensed as a bank (or are a bank subsidiary), are registered as broker-dealers, or advise mutual funds, are not currently obligated to adhere to the proposed BSA requirements. Since 1985, however, Sec. 6050I of the Internal Revenue Code of 1986, as amended, requires that all persons (including investment advisers) who, in their trade or business, receive more than $10,000 in "cash" in a transaction or a series of related transactions, file an information return on Form 8300 reporting same to the U.S. Internal Revenue Service; this information reporting requirement is mirrored in Section 5331 of the BSA. In addition to U.S. currency, foreign currency, cashier's checks, bank drafts, traveler's checks, and money orders, effective in 2024, "cash" will include digital currencies.

Scope of Proposed AML/CTF Requirements

FinCEN's proposed rule would require Investment Advisers to establish and maintain an effective written AML/CTF compliance program tailored to the specific risks associated with their business, and include the following:

Customer Due Diligence Requirements

Under the proposed rule, Investment Advisers would be required to establish risk-based procedures for ongoing customer due diligence ("CDD"). This includes conducting background checks on investors and clients to verify their identities, as well as assessing the nature and purpose of the client relationship.

Beneficial Ownership Reporting

Notably, the proposed rulemaking will not impose a customer identification program ("CIP") requirement. Instead, FinCEN expects to leverage the newly enacted Corporate Transparency Act ("CTA"), which was passed as part of the AML Act. The CTA requires certain types of domestic and foreign entities, called "reporting companies," to submit specified beneficial ownership information ("BOI") directly to FinCEN. In certain circumstances, FinCEN is authorized to share BOI with government agencies, financial institutions, and financial regulators, subject to appropriate protocols. Therefore, FinCEN expects that any future CIP requirements would be proposed jointly with the SEC in a separate rulemaking.

Suspicious Activity Reporting

In addition to Form 8300 filings, under the proposed rule Investment Advisers would be required to conduct "know your customer" due diligence to learn the nature and purpose of the client/investor relationship, which would form the baseline against which aberrant, suspicious transactions are identified. For transactions that do not have apparent business or lawful purpose or are not the sort in which clients or investors would normally be expected to engage, the Investment Adviser would be required to file suspicious activity reports ("SARs") with FinCEN.

While some investment advisers have willingly adopted internal AML/CTF programs that integrate various elements outlined in FinCEN's proposed rule, the introduction of the mandatory requirement to file SARs would represent an entirely new and unfamiliar requirement for almost all investment advisers and possibly create implementation challenges for many advisers.

AML Compliance Officer

Investment Advisers would be required to designate individual(s) responsible for implementing and overseeing an AML/CTF compliance program, including the standard elements of (i) tone from the top including access to senior management and adequate resources, (ii) risk assessments, (iii) internal controls, including personnel roles and responsibilities, (iv) testing and audit, and (v) personnel training. AML Compliance officers would be required to possess expertise in AML/CTF requirements, relevant policies, and the adviser's risk landscape. We expect that these duties may be put upon already strained Chief Compliance Officer roles.

Recordkeeping and Reporting

The proposed rule would require Investment Advisers to maintain and keep readily available detailed records of their AML/CTF efforts, including customer due diligence, suspicious activity reporting, and other relevant documentation.

Independent Testing and Audit

The proposed rule would require Investment Advisers to test and arrange an independent audit of their AML/CTF compliance programs. This measure aims to ensure the program's compliance with regulatory requirements and its effective functionality.

Training

The proposed rule would require Investment Advisers to provide AML/CTF compliance training to applicable personnel, including employees and independent contractors, to identify, interrupt and report illicit financial activities. The training program's nature, scope, and frequency should align with personnel responsibilities and their exposure to AML/CTF requirements. We typically refer to the various personnel roles as the "three lines of defense." The business unit serves as the first line of defense when interfacing with clients and investors. Compliance and legal personnel are the second line of defense and have primary responsibility for designing and implementing internal controls. The Audit department of an organization serves as the third line of defense and as a check on the effectiveness of the AML/CTF compliance program.

Next Steps

FinCEN seeks public input on the proposed rule, including with respect to 60 specific questions, which are due by April 15, 2024. Investment Advisers will be allowed a 12-month implantation period following the final rule's effective date to ensure compliance. We are monitoring developments in this space and anticipate providing updates as the proposed rule progresses.

Conclusion

This paper is intended as a guide only and is not a substitute for specific legal or ?tax advice. ???Please ??reach out to the authors for any specific questions. We expect ?to continue to monitor the ???topics ??addressed in this paper and provide future ?client updates when useful.

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