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Locke Lord QuickStudy: FUNDamentals: Is the Joint FinCEN and SEC Proposal for Investment Adviser Customer Identification Program DoA?

FUNDamentals™ Series

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On May 13, 2024, the U.S. Securities and Exchange Commission's Division of Investment Management ("SEC") and the U.S. Department of the Treasury's Financial Crimes Enforcement Network ("FinCEN") issued a joint proposal ("Proposed Rule") to require both SEC registered investment advisers ("RIAs") and exempt reporting advisers ("ERAs") to implement provisions of Section 326 of the USA PATRIOT Act of 2001, which amended the Bank Secrecy Act ("BSA") to require financial institutions to implement a Customer Identification Program ("CIP"). Under the Proposed Rule, RIAs and ERAs will be required to: (i) identify and verify the identity of any person who seeks to open an account with or invest in a fund managed by the RIA or ERA; (ii) maintain the information used to verify the person's identity, including name, address, date of birth for an individual or the date of formation of an entity, and identification number (e.g., social security number for an individual or employer identification number for an entity); and (iii) determine whether the person appears on any lists of known or suspected terrorists or terrorist organization issued by any government agency.

The BSA authorizes the Secretary of the U.S. Department of the Treasury (the "Secretary") to impose CIP requirements on twenty-four defined types of "financial institutions." Investment advisers, however, are not currently included in the definition. The Secretary is granted discretion under the BSA to add other entity types to this definition, such as investment advisers. The Proposed Rule builds upon a separate proposal issued by the Secretary on February 15, 2024, that would amend the definition of financial institution under the BSA to include certain persons meeting the definition of investment advisers under the Investment Advisers Act of 1940, as amended (the "Advisers Act") and subject them to anti-money laundering program requirements and obligations to file suspicious activity reports (*see* our March 7, 2024 FUNDamentals). This proposed change would apply to RIAs, ERAs, and any person who is otherwise required to be so registered under the Advisers Act, but would not extend to state registered or exempt investment advisers.

FinCEN stated in its May 13, 2024 press release: "the proposed rule would make it more difficult for criminal, corrupt, or illicit actors to establish customer relationships—including by using false identities—with investment advisers for the purposes of laundering money, financing terrorism, or engaging in other illicit finance activity."

In an SEC press release of the same date, the SEC solicited industry comment to ascertain whether to exclude "specific services . . . that do not involve management of client assets or subadvisory services." The SEC seeks to identify any "investment advisory services" that do not pose substantial risk of facilitating money laundering, terrorist financing, or other illicit financial activity, and which could potentially be carved out of the CIP

requirements. We note that “investment advisory services” is not defined in the Advisers Act. However, an “investment adviser” includes any person that, “either directly or through publications or writings,” is in the business of advising others “as to the value of securities” or who “issues or promulgates analyses or reports concerning securities.” Given the broad definition of investment adviser, the Proposed Rule could sweep in services of RIAs and ERAs that: (i) publish newsletters that are not for “general and regular circulation,” (ii) provide “model” investment strategies for wrap programs, and (iii) other services that do not include the transfer of cash or securities.

The SEC and FinCEN propose to coordinate development of the Proposed Rule such that both regulators will have a consistent approach to enforcement by effecting a two-step process whereby FinCEN will first determine the scope of covered investment advisory services, and next the SEC will determine the requirements for investment advisers to implement a CIP. This bifurcated approach is intended to streamline the effect and reduce the burden on investment advisers by limiting conflicts between FinCEN and SEC rulemaking.

We note that even with the regulators’ coordination to minimize the burden on RIAs and ERAs, SEC Commissioner Mark T. Uyeda issued a statement to oppose the proposed measure due to the increased compliance burdens to be imposed particularly on smaller RIAs and ERAs who are already struggling under substantial burdens of new compliance requirements.

As we have in the past, we will continue to monitor these issues and will provide future client updates. This QuickStudy is for guidance only and is not intended to be a substitute for specific legal or tax advice.

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