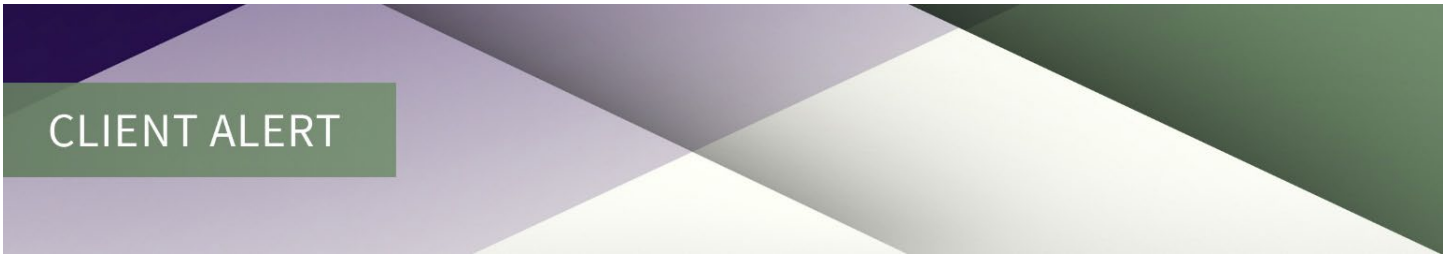

Third Time's a Charm: FinCEN Proposes AML Rule for Investment Advisers

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More than twenty years after first attempting to bring investment advisers within the scope of its anti-money laundering ("**AML**") / countering the financing of terrorism ("**CFT**") framework, the U.S. Department of Treasury's Financial Crimes and Enforcement Network ("**FinCEN**") issued a Notice of Proposed Rule Making[1] on February 15, 2024 that would impose various AML/CFT obligations on investment advisers. Currently, investment advisers are not required by federal or state law to maintain AML/CFT programs (although many do so voluntarily). According to FinCEN, this means that thousands of investment advisers overseeing the investment of tens of trillions of dollars into the U.S. economy are operating without legally binding AML/CFT obligations, which FinCEN alleges is a gap that can be exploited by money launderers, terrorist financers, and other actors who seek access to the U.S. financial system for illicit purposes via investment advisers.

Now, for the third time, FinCEN proposes to achieve its long-standing goal of closing this gap by adding "investment adviser" to the definition of "financial institution" under the Bank Secrecy Act ("**BSA**") and implementing regulations,[2] which would establish AML/CFT requirements for such advisers, as discussed in detail below. Specifically, FinCEN proposes to include two types of advisers, which are collectively referred to as "**Covered Investment Advisers**":

1 Financial Crimes Enforcement Network: Anti-Money Laundering/Countering the Financing of Terrorism Program and Suspicious Activity Report Filing Requirements for Registered Investment Advisers and Exempt Reporting Advisers, 89 FR 2108 (Feb. 15, 2024) (the "**Proposed Rule**").

2 31 C.F.R. 1010.100(t).

1. Investment advisers that are registered or required to register with the U.S. Securities and Exchange Commission ("**SEC**," and such investment advisers, "**RIAs**") and

2. investment advisers that report to the SEC as Exempt Reporting Advisers ("**ERAs**") pursuant to the Investment Advisers Act of 1940 and the rules thereunder.[3]

If the Proposed Rule goes into effect, Covered Investment Advisers will likely need to devote significant resources to comply with these new requirements, especially to the extent they do not already voluntarily maintain an AML/CFT compliance framework. Comments to the Proposed Rule must be submitted on or before April 15, 2024. As proposed, covered investment advisers would have **one year from the effective date** to come into compliance.

Core Requirements of the Proposed Rule

By becoming "financial institutions" under the BSA and implementing regulations, Covered Investment Advisers would be required to (1) establish AML/CFT programs; (2) file Suspicious Activity Reports ("**SARs**") and Currency Transaction Reports ("**CTRs**") with FinCEN; and (3) keep records relating to the transmittal of funds. Although many investment advisers are familiar with FinCEN's AML/CFT framework due to their relationships and affiliations with banks, broker-dealers, and other regulated financial institutions, we highlight key aspects of these core requirements below.

1. **Establish AML/CFT programs**. Under the Proposed Rule, Covered Investment Advisers would be required to establish and maintain AML/CFT programs that are risk-based and reasonably designed to prevent an investment adviser's services from being used for money laundering, terrorist financing, or other illicit finance activities.[4] Although FinCEN acknowledges that there is no one-size-fits-all solution, several elements are nonetheless required for an AML/CFT program to be considered effective by FinCEN, including:

    - **Required Policies, Procedures and Internal Controls**.[5] Covered Investment Advisers would be required to review the types of advisory services they provide, the nature of the clients they advise, the investment products offered, distribution channels, intermediaries, and the geographic locations of clients and business activities to identify their vulnerabilities to money laundering. The Proposed Rule provides a few examples of how an investment adviser's AML/CFT program may address and mitigate the risks presented by specific advisory clients including, registered closed-end funds, private funds, and wrap fee programs.

[3] Proposed Rule Section I.

[4] Proposed Rule Section IV(E)(6).

[5] 31 C.F.R. 1032.210(b)(1), Proposed Rule Section IV(E)(6)(A).

- **Independent Testing**.[6] Investment advisers would be required to provide for independent testing of their AML/CFT program by their personnel or a qualified outside party. The frequency of such testing is dependent on the risks posed by the investment advisers' businesses. Any recommendations resulting from such testing would need to be promptly implemented or submitted to senior management for consideration.

- **Designate a Person or Persons Responsible for Implementing and Monitoring the Operations and Internal Controls of the Program**.[7] One or more persons must be designated to be responsible for implementing and monitoring the AML/CFT program. The person(s) should be knowledgeable and competent regarding AML/CFT requirements, the adviser's relevant policies, procedures, and controls, as well as the adviser's risk factors. The person(s) should have full responsibility and authority to develop and implement appropriate policies, procedures, and internal controls and should also have established channels of connection with senior management demonstrating sufficient independence and access to resources to implement the AML/CFT program.

- **Provide Ongoing Training for Appropriate Persons**.[8] Employee training is considered an integral part of AML/CFT programs, and Covered Investment Advisers would be required to provide for the ongoing training of employees (and of any agent or third-party service provider charged with administrating any portion of the investment advisers' AML/CFT program) in the requirements that are relevant to their functions and to recognize possible signs of money laundering, terrorist financing, and other illicit finance activity that could arise in the course of their duties. The training program should provide a general awareness of AML/CFT requirements and risks, as well as more job-specific guidance tailored to employees' roles and functions. Employees whose duties bring them in contact with AML/CFT requirements or possible money laundering, terrorist financing, or other illicit finance risks should undergo training when they assume those duties and should receive periodic updates and refreshers regarding the AML/CFT program.

  Notably, the Proposed Rule does not apply to the advisory services that Covered Investment Advisers provide to open-end investment companies that are registered under the Investment Company Act of 1940 ("**mutual funds**"). FinCEN believes that including mutual funds within the Proposed Rule would be redundant since mutual funds are separately defined as financial

6 31 C.F.R. 1032.210(b)(2), Proposed Rule Section IV(E)(6)(B).
7 31 C.F.R. 1032.210(b)(3), Proposed Rule Section IV(E)(6)(C).
8 31 C.F.R. 1032.210(b)(4), Proposed Rule Section IV(E)(6)(D).

institutions and are already required to maintain their own AML/CFT programs.[9] For this reason, FinCEN is proposing to exempt Covered Investment Advisers from complying with reporting and recordkeeping requirements for their mutual fund clients and, as currently drafted, the Proposed Rule would not require Covered Investment Advisers to file SARs with respect to any mutual fund they advise.[10]

2. **File Reports**. Under the Proposed Rule, Covered Investment Advisers would also be required to file SARs with FinCEN.[11] Covered Investment Advisers would be required to report, within 30 days of detection, 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.[12] The proposed requirement is generally consistent with the SAR filing requirements for other types of financial institutions under existing regulations. FinCEN notes that it would expect that requiring investment advisers to report suspicious activity would provide highly useful information for investigations and proceedings involving domestic and international money laundering, terrorist financing, and other illicit finance activity, as well as for intelligence purposes.

   Covered Investment Advisers would also be required to file a CTR for a transaction involving a transfer of more than $10,000 in currency by, through, or to the investment adviser, unless subject to an applicable exemption.[13] This would replace the existing requirement for investment advisers to file similar reports using the joint FinCEN/Internal Revenue Service Form 8300.[14]

3. **Maintain Records**.[15] Under the Proposed Rule, Covered Investment Advisers would further be required to comply with the existing Recordkeeping and Travel Rules which are codified at 31 CFR 1010.410(e) and 31 CFR 1010.410(f). These rules require financial institutions to create and retain records for transmittals of funds and ensure that certain information pertaining to the transmittal of funds "travels" with the transmittal to the next financial institution in the payment chain. Currently, the Recordkeeping and Travel Rules apply to transmittals of funds that equal or exceed $3,000.

Finally, we note that the Proposed Rule would also apply information-sharing provisions between and among FinCEN, law enforcement government agencies, and certain financial institutions, and would require investment advisers to comply

9 Proposed Rule Section IV(E)(2)(A).

10 *Id*.

11 31 C.F.R. 1032.320, Proposed Rule Section IV(F)(2).

12 31 C.F.R. 1032.320(a)(1) and (2), Proposed Rule Section IV(F)(1).

13 *See* 31 C.F.R. 1010.311.

14 Proposed Rule Section IV(C).

15 *See* 31 C.F.R. 1010.410(e)(1)(i), (e)(2).

with "special measures" imposed by FinCEN on financial institutions and certain sectors pursuant to section 311 of the USA PATRIOT Act.

No Customer Identification Program ("CIP") Requirement At This Stage

While normally a feature of a regulated financial institution's AML/CFT program, FinCEN has not proposed at this stage to include formal CIP requirements for Covered Investment Advisers to identify and verify the identity of their clients or to collect beneficial ownership information for their legal entity clients.[16] Rather, FinCEN has indicated that it will address these requirements in a future joint rulemaking with the SEC.

The timing and substance of this future joint rulemaking will undoubtedly depend on anticipated, forthcoming revisions that FinCEN is required to make to the existing Customer Due Diligence ("**CDD**") framework applicable to banks, mutual funds, broker-dealers, futures commission merchants, and introducing brokers in commodities. Specifically, FinCEN is required to amend the existing CDD framework to remove existing beneficial ownership identification and verification requirements that are now unnecessary or duplicative in light of the Corporate Transparency Act (passed into law on January 1, 2021), which separately requires certain types of entities to report beneficial ownership information to FinCEN.[17] FinCEN must make these conforming revisions to the CDD framework by January 1, 2025.

Investment Advisers Outside the United States[18]

Many investment advisers are located outside the United States or conduct certain of their operations outside the United States. FinCEN notes that it seeks to harmonize its AML/CFT framework in a manner consistent with the SEC's existing registration requirements for non-U.S. investment advisers. Consistent with longstanding SEC practice and guidance interpreting investment adviser registration requirements under the Advisers Act, unless subject to an exemption, investment advisers located abroad generally must register with the SEC if they "make use of the mails or any means or instrumentality of interstate commerce in connection with [their] business as an investment adviser."[19] Thus, the Proposed Rule's requirements would apply to non-U.S. RIAs and ERAs that, respectively, are registered or required to register with the SEC or report to the SEC on Form ADV.

16 Proposed Rule Section IV(E)(6)(E).

17 For more details on this aspect of the Corporate Transparency Act, please see: Anti-Money Laundering Act of 2020 Overhauls United States AML Framework (Feb. 1, 2021); FinCEN Finalizes Rule on Beneficial Ownership Reporting Requirements (Oct. 21, 2022); Preparing for the Corporate Transparency Act Reporting Requirements (Oct. 10, 2023); and Are You Ready to Report? Here's What You Need to Know about the Corporate Transparency Act (Dec. 26, 2023).

18 Proposed Rule Section IV(E)(7).

19 *See* 15 U.S.C. 80b–3(a).

Importantly, the duty to establish and maintain an AML/CFT program (detailed above) must remain the responsibility of, and be performed by, persons in the United States who are accessible and subject to federal oversight and supervision.[20] FinCEN recognizes that Covered Investment Advisers (as well as other financial institutions) may currently have AML/CFT staff and operations outside of the United States to improve cost efficiencies, enhance coordination with respect to cross-border operations, or for other reasons. FinCEN therefore requests comment on a variety of potential questions or challenges that may arise for Covered Investment Advisers as they address this requirement.

Delegation of Examination Authority to SEC

FinCEN is proposing to delegate its examination authority to the SEC, given the SEC's expertise in the regulation of investment advisers and the existing delegation to the SEC of authority to examine broker-dealers and certain investment companies.

Conclusion

The Proposed Rule is a serious attempt by FinCEN to address what it sees as a significant vulnerability in the U.S. financial system, after abandoned attempts in 2003 and 2015. If the Proposed Rule goes into effect, these new requirements will be a significant change to the status quo and will have wide-reaching impacts on RIAs and ERAs, even those who have voluntarily implemented AML/CFT programs before now.[21] We encourage investment advisers that will be affected by the Proposed Rule to contact us for advice on submitting a comment, or to submit a comment directly, before the April 15, 2024 deadline.

[20] 31 C.F.R. 1032.210(d), Proposed Rule Section IV(E)(7), incorporating 31 U.S.C. 5318(h)(5).

[21] FinCEN estimates that, in total, there are approximately 15,391 RIA's and 5,846 ERAs that will be captured by the regulations. NPRM Section IV(A)(2)(A)(II).

If you have any questions regarding this client alert, please contact the following attorneys or the Willkie attorney with whom you regularly work.

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