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CLIENT MEMORANDUM

Treasury Department Proposes Anti-Money Laundering Regulations for Investment Advisers

August 28, 2015

AUTHORS

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On August 25, 2015, the U.S. Department of the Treasury's Financial Crimes Enforcement Network ("FinCEN") released proposed anti-money laundering ("AML") regulations that would require investment advisers registered or required to register with the SEC ("Advisers") to have written AML programs meeting certain minimum requirements under the Bank Secrecy Act (the "BSA").[1]

- The proposed regulations would require Advisers to: have written AML policies meeting the minimum requirements for internal AML controls, procedures, and supervision, employee training, and independent testing; file suspicious activity reports ("SARs"); and comply with certain recordkeeping and reporting rules.
- Although many Advisers have already implemented AML policies incorporating best practices that parallel some of the proposed regulatory requirements, the FinCEN proposal includes some features that may be unfamiliar to Advisers, including requirements for independent audit of their AML programs and the filing of SARs.

[1] The proposed regulations may be viewed here.

- The proposed regulations would also subject Advisers to recordkeeping, cash transaction reporting, and information-sharing obligations, and provide Advisers with liability protections for certain disclosures and information-sharing in furtherance of AML law enforcement activities.

- The regulations are expected to take effect six months following publication of the final version in the Federal Register and therefore will probably become mandatory by mid-2016.

The proposed regulations are subject to a 60-day public comment period, followed by FinCEN's review of the comments and any necessary revisions. As part of its release, FinCEN proposed a significant number of questions for public comment regarding the anticipated scope and effect of the proposed regulations and it is likely that some details of the proposed regulations will be revised in response to the comments received, particularly from the Adviser industry.

Advisers should take advantage of this lead time to evaluate their current AML policies and procedures and prepare for the new requirements. In particular, Advisers should consider how they will establish internal mechanisms for flagging suspicious activities that will be reportable under the new regulations.

THE PROPOSED REGULATIONS

If adopted as proposed, the regulations would apply to "any person who is registered or required to register with the SEC under Section 302 of the Investment Advisers Act of 1940" and would be enforced by the SEC on FinCEN's behalf. Advisers would be included in the definition of "financial institution" in the BSA regulations, a factor that could subject them to other AML regulations—in addition to those currently proposed—in the future.

1. AML Programs

The proposed regulations would require an Adviser to implement a written AML program that has been approved in writing by its board of directors or trustees, or by its sole proprietor, general partner, or other person having comparable authority. The AML program must, at a minimum—

- ***Establish and implement policies, procedures, and internal controls designed to prevent the Adviser from being used for money laundering or the financing of terrorist activities and to achieve compliance with the applicable federal AML requirements*.**

  In general, each Adviser's AML program should be based on the level of money-laundering risk it anticipates in the conduct of its business operations. Although the proposed regulations do not require Advisers to implement the "Know Your Customer" requirements currently applicable to banks or broker-dealers, a carefully crafted risk-based AML program would typically include due diligence procedures that recognize such factors as the money-laundering risk level of the jurisdictions in which it does business and the risks posed by particular types of clients and counterparties (e.g., individuals, AML-regulated financial institutions, or pooled investment vehicles, such as

private funds and other unregistered pooled investment vehicles).

Under the proposed regulations, Advisers would be permitted to delegate the implementation and operational aspects of their AML programs to third-party service providers, such as fund administrators, by contract.

- ***Provide for independent testing of the program to be conducted by the Adviser's personnel or by a qualified outside party to ensure compliance with the applicable AML rules.***

  Such testing may be conducted either by an unaffiliated service provider or by the Adviser's own employees, as long as the employees are knowledgeable about AML requirements and are not themselves involved in the operation and oversight of the AML program. The proposed regulations do not specify the frequency of such testing, which FinCEN notes should depend on the Adviser's assessment of its AML risks. The results of such testing must be promptly implemented or submitted to senior management for consideration.

- ***Designate an individual (or a group of individuals) to implement and monitor implementation of the program*.**

  According to FinCEN, an individual designated under this provision should be an officer of the Adviser. Compliance oversight may also be assigned to a committee. The designated individual(s) should be knowledgeable and competent regarding the regulatory requirements and the Adviser's money-laundering risks, and should have full responsibility and authority to develop and enforce the appropriate policies and procedures.

- ***Provide ongoing training for appropriate persons*.**

  The proposed regulations require that Adviser employees be trained and receive periodic updated training in BSA requirements pertinent to their professional responsibilities, including the ability to recognize money-laundering "red flags" that may be encountered in the course of their duties. Training may be conducted through outside or in-house seminars, but its nature, scope, and frequency should be determined by the extent to which the employees' responsibilities bring them in contact with BSA requirements or possible money-laundering activity. Although many Advisers already provide AML training to their employees, that training would have to be supplemented by additional instruction, if the proposed regulations are adopted, regarding such skills as recognizing suspicious activity that would be reportable under the regulations.

2. Suspicious Activity Reporting

Advisers would be required to prepare and submit a SAR in connection with a transaction "conducted or attempted by, at, or through" an Adviser if it involves or aggregates at least $5,000 in funds or other assets and the Adviser "knows,

suspects, or has reason to suspect" that the transaction, or a pattern of transactions of which the particular transaction is a part—

- Involves funds derived from illegal activity, or is intended to hide or disguise such funds as part of a plan to violate or evade any federal law, any transaction reporting requirement under federal law, or any BSA requirement;
- Has no business or apparent lawful purpose or is outside the sort of transaction in which the particular counterparty would normally engage, and the Adviser knows of no reasonable explanation for the transaction after considering the available facts; or
- Involves use of the Adviser to "facilitate criminal activity." A reportable transaction broadly includes "any suspicious transaction relevant to a possible violation of law or regulation."

Under the proposed regulations, Advisers would obtain the benefit of the BSA's "safe harbor" provision, which shields a financial institution that files a SAR from civil liability.[2] Advisers would also be subject to strict confidentiality requirements regarding SARs, but FinCEN has requested public comment as to whether Advisers should be permitted under the final regulations to share certain SAR-related information with affiliates and certain others.

3. Other Requirements

The proposed regulations would subject Advisers to certain recordkeeping rules, require Advisers to file reports with the Treasury Department regarding the receipt of cash (i.e., currency) and certain negotiable instruments using a FinCEN "Cash Transaction Report" instead of the currently required Form 8300, and mandate participation in FinCEN's program for special AML information-sharing. As a participant in that program, an Adviser (1) must search its records, in response to an inquiry from FinCEN, to determine whether it has maintained an account or conducted a transaction with a person that is suspected by law enforcement authorities of engaging in terrorist activity or money laundering, and (2) would be permitted to share certain investor and other information with another AML-regulated financial institution, under a safe harbor that offers protections from liability, in order to identify and report potential money laundering or terrorist activities.

[2] Specifically, under the applicable provision of the BSA, "[a]ny financial institution that makes a voluntary disclosure of any possible violation of law or regulation to a government agency or makes a disclosure pursuant to this subsection or any other authority, and any director, officer, employee, or agent of such institution who makes, or requires another to make any such disclosure, shall not be liable to any person under any law or regulation of the United States, any constitution, law, or regulation of any State or political subdivision of any State, or under any contract or other legally enforceable agreement (including any arbitration agreement), for such disclosure or for any failure to provide notice of such disclosure to the person who is the subject of such disclosure or any other person identified in the disclosure." 31 U.S.C. § 5318(g)(3)(A). Note, however, that "person" in this context does not include a governmental entity.

FinCEN SEEKS PUBLIC COMMENTS

FinCEN has stated its interest in receiving public comment not only on the proposed regulation but also on a series of questions posed in the release pertaining to, among other things, the following:

- "Should the regulations apply to large Advisers that qualify for and use an exemption from the requirement to register with the SEC?
- "Should foreign Advisers that are registered or required to register with the SEC, but that have no place of business in the United States, be included in the definition of investment adviser?
- "Should a subadviser to a private fund or other unregistered pooled investment vehicle, which has a primary adviser that is not an investment adviser, be required to establish the same policies and procedures as when the primary adviser is an investment adviser?
- "If an underlying investor in the private fund or other unregistered pooled investment vehicle is an investing pooled entity, should a subadviser be required to identify risks and incorporate policies and procedures within its AML program to mitigate the risks of the investing pooled entity's underlying investors, sponsoring entity, and/or intermediaries when there is an increased risk of money laundering, terrorist financing, or other illicit activity?
- "Should an adviser to a wrap fee program be required to obtain additional information about the investors in the program and/or coordinate its review with the sponsoring broker-dealer when the adviser sees an increased risk for money laundering, terrorist financing, or other illicit activity?"

The public comment period for this proposal will conclude 60 days after its expected publication in the Federal Register during the week of August 31, 2015. Given the breadth and diversity of the investment advisory industry, it is expected that there will be a large number of comments from Advisers and industry groups.

If you have any questions regarding this memorandum, please contact Benjamin J. Haskin (202-303-1124; bhaskin@willkie.com), Russell L. Smith (202-303-1116; rsmith@willkie.com), Barbara Block (202-303-1178; bblock@willkie.com) or the Willkie attorney with whom you regularly work.

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August 28, 2015