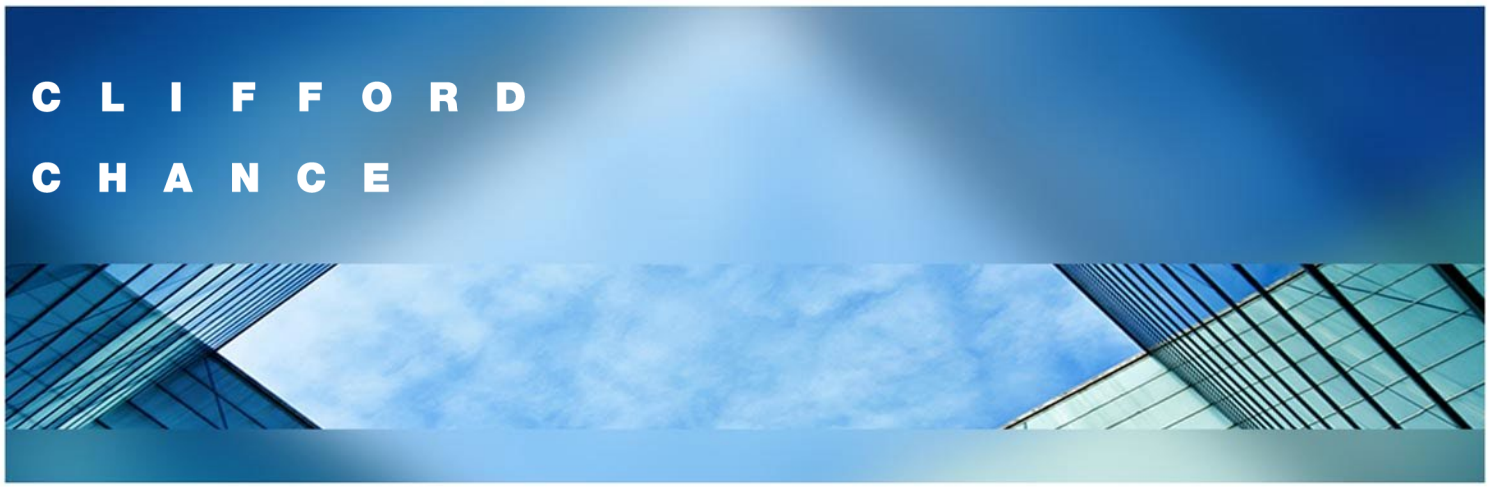

FINCEN PROPOSES EXPANDING THE BSA TO INVESTMENT ADVISERS . . . AGAIN

Includes Broad Extraterritorial Application and Potential Confusion over "Customer's Customer" Due Diligence

REGISTERED INVESTMENT ADVISERS AND EXEMPT REPORTING ADVISERS WITHIN SCOPE

On February 12, 2024, FinCEN issued a Notice of Proposed Rule Making (**NPRM**)[1] that would add investment advisers – both Investment Advisers registered with the US Securities & Exchange Commission (**SEC**) (**RIAs**) and investment advisers eligible for the private fund adviser exemption under the Investment Advisers Act of 1940, as amended (**Advisers Act**) who report as Exempt Reporting Advisers (**ERAs**) – to the list of businesses classified as "financial institutions" under FinCEN's regulations. The NPRM would subject both groups to most of the Anti-Money Laundering (**AML**) and Countering the Financing of Terrorism (**CFT**) requirements under the Bank Secrecy Act (**BSA**) that already exist for other financial institutions such as banks and securities brokers-dealers. Under the proposal, an investment adviser subject to the rule would have to comply with the proposed rule's requirements within 12 months of its ultimate effective date (which is yet to be determined).

As part of the current rulemaking, FinCEN has withdrawn a rule proposed in 2015 that would have only included RIAs within the scope of the requirements. The

[1] Proposed 31 CFR Parts 1010 and 1032, RIN 1506-AB58, Department of the Treasury, https://public-inspection.federalregister.gov/2024-02854.pdf. 89 FR 12108 (February 15, 2024).

current rulemaking, as well as a detailed Treasury Department Risk Assessment on the Investment Adviser sector, released shortly before the NPRM,[2] both describe the Investment Adviser sector as being a convenient entry point for foreign actors and foreign nation states seeking access to the U.S. economy in connection with illicit activities. Thus, FinCEN has expanded the proposal to include ERAs, which are advisers not subject to the full panoply of rules under the Advisers Act, who advise funds that are exempt from the requirements of the Investment Company Act of 1940, as amended (**Investment Company Act**), and are typically located offshore. FinCEN is proposing that ERAs be treated similarly to RIAs for **AML** purposes. Per the proposal, FinCEN would delegate examination authority and compliance oversight with the new regulations to the SEC, potentially expanding the SEC's reach further into the global private funds industry. These proposed requirements if enacted will pose implementation challenges for covered non-US investment advisers given existing US requirements that require firms to keep certain critical AML program operations within the United States.[3]

The practical import of the NPRM, which FinCEN expects to finalize later this year after considering public comments (due by April 15), will be new expectations and greater scrutiny with respect to how Investment Advisers conduct due diligence on prospective clients, including understanding the nature and purpose of the client relationship for the purpose of developing a client risk profile and conducting ongoing monitoring to report suspicious activity. FinCEN is not proposing that existing Customer Identification Programs (**CIP**) requirements be extended to investment advisers now but expects to impose such rules in the future pending broader regulatory changes required by the Corporate Transparency Act.[4]

GENERAL BACKGROUND: INVESTMENT ADVISERS SUBJECT TO RECLASSIFICATION

The proposed rule includes the following investment advisers in the classification of "financial institution" as defined in the BSA:

Registered Investment Advisers

RIAs are defined as "any person who is registered or required to register with the SEC under section 203 of the Advisers Act."

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2 2024 Investment Adviser Risk Assessment, Department of the Treasury, https://home.treasury.gov/system/files/136/US-Sectoral-Illicit-Finance-Risk-Assessment-Investment-Advisers.pdf

3 As of now, the proposed rule would not apply to State-Registered Investment Advisers. Although FinCEN states that it will continue to monitor the situation with respect to State-Registered Investment Advisers and consider rules in the future. FinCEN notes that few examples have surfaced to date indicating that such institutions, which are generally smaller in size, are being misused for money laundering, terrorist financing, or other illicit activities.

4 Briefing, "FinCEN Has Begun Accepting Beneficial Ownership Interest Reports Under The Corporate Transparency Act," Clifford Chance LLP, Feb. 16, 2024, https://www.cliffordchance.com/briefings/2024/01/fincen-has-begun-accepting-beneficial-ownership-interest-reports0.html (The Corporate Transparency Act, which requires legal entities to report beneficial ownership information straight to FinCEN, also requires FinCEN to modify its regulations with respect to Customer Due Diligence and Beneficial Ownership Information collection, with such modifications yet to be proposed).

Exempt Reporting Advisers

ERAs are defined as "any person that currently is exempt from registration under section 203(l) or 203(m) of the Investment Advisers Act." ERAs are advisers who are eligible for the Private Fund[5] Adviser Exemption or the Venture Capital Adviser Exemption.[6] The Venture Capital Adviser Exemption is available to investment advisers who solely advise venture capital funds.

PROPOSED OBLIGATIONS FOR INVESTMENT ADVISERS

Under the NPRM, RIAs and ERAs within the amended definition of "financial institutions" would be required to do the following, consistent with existing requirements for banks and broker dealers.[7]

1. Implement written, board-approved AML/CFT programs, including risk-based procedures for conducting customer due diligence (CDD).
    - Like other regulated financial institutions, the minimum requirements for such a program would include:
        - Establishing internal policies, procedures, and controls reasonably designed to prevent the investment adviser from being used for money laundering, terrorist financing or other illicit activity.
        - Independent testing of such program.
        - Designation of a BSA compliance officer responsible for implementing and monitoring program.
        - Ongoing training for appropriate persons.
        - Appropriate risk-based customer due diligence for the purpose of understanding the nature and risk profile of the customer and monitoring for suspicious activity.
2. Report suspicious activity reports and file Currency Transaction Reports with FinCEN.
    - Like other regulated financial institutions, covered Investment Advisers would be expected to file a Suspicious Activity Report (**SAR**) with FinCEN on transactions involving an aggregate of $5,000 or more when the

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5 A "private fund" is an issuer of securities that would be an "investment company" but for the exceptions in Sections 3(c)(1) and 3(c)(7) of the Investment Company Act — that is, an investment fund limited to no more than 100 accredited investors or investors who are both accredited investors and qualified purchasers, respectively. Eligibility for the Private Fund Adviser Exemption requires that less than $150 million of the adviser's regulatory assets under management is managed from a place of business in the United States.

6 A "venture capital fund," as defined in the Advisers Act, is a private fund that 1) invests no more than 20 percent of its total capital in assets other than "qualifying investments" and short-term holdings; 2) does not incur leverage in excess of 15 percent of its aggregate capital contributions and uncalled committed capital, and any such leverage is for a non-renewable term of no longer than 120 calendar days; 3) does not offer its investors liquidity rights except in extraordinary circumstances; 4) is not registered under the Investment Company Act; 5) has not elected to be treated as a business development company; and 6) represents that it pursues a venture capital strategy.

7 *Id.*; Fact Sheet. Anti-Money Laundering Program and Suspicious Activity Report Filing Requirements for Registered Investment Advisers and Exempt Reporting Advisers Notice of Proposed Rulemaking (NPRM), FinCEN, Feb. 13, 2024. https://www.fincen.gov/news/news-releases/fact-sheet-anti-money-laundering-program-and-suspicious-activity-report-filing

Investment Adviser suspects or has reason to suspect that the transaction involves:

- Funds derived from illegal activity.
- An intention to evade reporting or other BSA requirements.
- No business purpose or apparent lawful purpose and cannot be reasonably explained as part of the customer's business.
- Use of the Investment Adviser to facilitate criminal activity.

- Investment Advisers will also be required to report via a Currency Transaction Report (CTR) on transactions involving a receipt or disbursement of more than $10,000 in currency for a single customer in a single day.

3. Comply with the Recordkeeping and Travel Rule.
   - Investment Advisers will be required to maintain records of originators and beneficiaries (transmitters and recipients) with respect to "transmittal orders" of $3,000 or more. Note that in imposing this requirement, FinCEN acknowledges that there are certain business models by which an Investment Adviser receiving a customer's instructions might not be receiving funds into its account which is a component of the FinCEN definition for transmittal order. FinCEN is seeking comment that may help it better tailor this rule to practices of Investment Advisers.
4. Apply information-sharing provisions between and among FinCEN, law enforcement and certain financial institutions.
   - Under the prosed rule, as financial institutions Investment Advisers will now need to respond to any requests for information regarding targeted USG investigations via FinCEN's requests under Sec. 314a of the PATRIOT ACT. In addition, Investment Advisors may also participate in voluntary information with other financial institutions under the authority of Sec. 314b of the PATRIOT ACT.
5. Impose special due diligence requirements for correspondent and private banking requirements, including compliance with special measures implemented under Section 311 of the Patriot Act.
   - Under the prosed rule, Investment Advisers (considered as financial institutions) will now need to comply with the special and enhanced due diligence requirements established for correspondent relationships. Such relationships in this context include an "account," or "any contractual or other business relationship established between a person and an investment adviser to provide advisory services." They would also have to comply with any of the requirements issued in the future with respect to FinCEN's restrictions for covered financial institutions in dealings with jurisdictions, entities, or classes of transactions identified as primary

money laundering concerns pursuant to its authorities under Sec. 311 of the PATRIOT Act.

POTENTIAL PENALTIES FOR NONCOMPLIANCE

Any violation of the proposed rule may constitute a violation of the BSA and FinCEN regulations, subjecting violators to FinCEN's authority to impose civil penalties under the same law and regulations. Fines and penalties can be quite large. For example, pursuant to the latest adjustment of its penalties, FinCEN may impose a Civil Money Penalty of roughly $70,000 per day for willful violations of the requirement to implement and maintain an effective AML program. For each willful violation of a SAR reporting requirement, FinCEN may impose a Civil Money Penalty not to exceed the greater of the amount involved in the transaction (capped at $270,180) or $70,000.

"CUSTOMERS," "CLIENTS," AND "INVESTORS"

Although the proposed rule does not include a specific definition of a "customer" in the investment adviser context, FinCEN suggests that it is using the term "customer" for those natural and legal persons that enter into an advisory relationship with an investment adviser, acknowledging that the Advisers Act and its implementing regulations use the term "client."[8] In this context, the implication in the proposed rule is that the two terms are synonymous.

In its discussion of how the rule applies with respect to investment advisers whose customers/clients are private funds, FinCEN acknowledges that investors in a fund are not themselves customers of the adviser unless a separate advisory relationship exists between the investor and the adviser. This has bearing on the level of customer due diligence that FinCEN will expect from investment advisers subject to the rule. KYC requirements in the AML context generally do not include a requirement to know a "customer's customer." In applying this concept to the proposed rule, although FinCEN acknowledges that an investor in a fund is generally not a customer of the investment adviser, it suggests that there will be times when, on a risk-based approach, an investment adviser will need to have enough information about the investors in a fund, as a group or even with respect to particular investors, to be able to meet the general AML program requirement to reasonably prevent the investment adviser from being used to launder money or finance terrorism.

FinCEN provides the following discussion acknowledging that a risk-based approach applies:

"…the risk-based approach of the proposed rule is intended to give investment advisers the flexibility to design their programs to meet the specific risks presented by their customers, including any funds they advise. In assessing the potential risk of a private fund under the proposed rule, investment advisers generally should gather pertinent facts about the

[8] NPRM, 89 FR at 12109, fn. 18.

structure or ownership of the fund, including both the extent to which they are provided with relevant information about the investors in that private fund, who may or may not themselves also be customers of the investment adviser, and the nature of such investor-related information that they receive."[9]

FinCEN, however, then emphasizes that where an investment adviser may not have information on investors in a fund, it subjects itself to higher levels of risk that will have to be managed:

"Under the proposed rule, where an investment adviser attempted to and was unable to obtain identifying information about the investors in a private fund, the private fund may pose a higher risk for money laundering, terrorist financing, or other illicit finance activity. When a private fund's potential vulnerability to money laundering, terrorist financing, or other illicit finance activity is high, the adviser's procedures would need to reasonably address these higher risks so that the adviser is able to prevent the investment adviser from being used for money laundering or the financing of terrorist activities, and to achieve and monitor compliance with the BSA (including to obtain sufficient information to monitor and report suspicious activity). FinCEN requests comment on what information is currently available to advisers to private funds regarding their investors that could help advisers comply with the proposed AML/CFT requirements."[10]

Finally, FinCEN explains that different types of funds might present different levels of risks resulting in different expectations of reasonable diligence, but without providing further clarity. In summary, as the foregoing illustrates, the industry will ultimately need such clarity. Although further direction may come with FinCEN's consideration of industry comments when issuing the final investment adviser rule, separately pending rules on what constitutes an effective AML program will also be relevant.[11]

WHY THIS MATTERS FOR THE INVESTMENT MANAGEMENT AND PRIVATE FUNDS INDUSTRY

Given the fact that, as proposed, many non-US based RIAs and ERAs would be subject to the proposed rules, there are practical implications that FinCEN will have to consider, including: (1) how the SEC structures its examination program; (2) how these entities will comply with certain FinCEN regulations, such as the

9 NPRM, 89 FR at 12126

10 NPRM, 89 FR at 12127.

11 The NPRM for investment advisers needs to be considered in the context of broader regulatory developments still pending under of The Anti-Money Laundering Act of 2020 ("**AMLA**"). Per the President's Unified Agenda published in Fall 2023, FinCEN intends in March 2024, to issue a separate notice of proposed rulemaking as part of the establishment of national exam and supervision priorities. That separate rule will implement section 6101(b) of [AMLA] which requires the Secretary of the Treasury to issue and promulgate rules for financial institutions to carry out government-wide AML/CFT priorities. FinCEN expects the national exam and supervision priorities rule to: (i) incorporate a risk assessment requirement for financial institutions; (ii) require financial institutions to incorporate AML/CFT Priorities into risk-based programs; and (iii) provide for certain technical changes. FinCEN notes that "once finalized, this rule will affect all financial institutions subject to regulations under the BSA that have AML/CFT program obligations."

requirement that US-based personnel be responsible for primary administration of AML programs; (3) the tension between maintaining the confidentiality of SARs and other information that might be generated in or otherwise subject to the laws of a foreign jurisdiction; and (4) the application of the proposed rules to the non-US business of non-US based advisers. FinCEN has requested comment on (i) whether non-US RIAs should be included, and (ii) whether ERAs should be excluded and, if excluded, how FinCEN could address the AML and CFT risks associated with ERAs. Clarifying all these threshold issues during the rule-making process will be critical, particularly for non-US based RIAs and ERAs.

Although the proposed rule does not require RIAs and ERAs to have in place a CIP program or to comply with the beneficial ownership rules, the proposal indicates that such requirements would be the subject of future proposed rulemaking. Even without a CIP requirement, however, RIAs and ERAs would still need to collect sufficient information on their customers to meet general Customer Due Diligence requirements and to implement an effective monitoring program for identifying suspicious activity.

CONCLUSION

The NPRM, if approved in its current form, will formally place affirmative AML requirements on the investment management and funds industry. Although many RIAs and ERAs have had AML program and suspicious activity monitoring requirements in place for some time, the new rule would standardize the requirements across the industry. In addition, the newly proposed rule --with its increased scope to cover ERAs -- could have wide effects on how investment advisers collect, report, and possibly share information, how banks will interact with these entities moving forward, and how the sector deals with an expanded examination dynamic under the SEC as FinCEN's delegated watchdog. Our financial regulatory and fund experts are following these developments closely and assisting clients with advocacy as well as preparation for compliance with the proposed rules.

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