FINCEN EXPANDS AML/CTF PROGRAM REQUIREMENTS TO COVER EXEMPT REPORTING ADVISORS

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PLEASE NOTE THAT THE COMMENT PERIOD FOR THE FOLLOWING PROPOSED RULEMAKING IS OPEN UNTIL APRIL 15, 2025.

On February 13, 2024, the Financial Crimes Enforcement Network ("FinCEN") of the U.S. Treasury took a decisive step toward expanding the compliance obligations of certain types of investment advisers. By withdrawing its 2015 proposal and introducing a new set of proposed rules (the "Proposed Rules"), FinCEN aims to strengthen Anti-Money Laundering/Counter-Terrorist Financing ("AML/CTF") measures among Registered Investment Advisers ("RIAs") and SEC Exempt Reporting Advisers (ERAs). This update signifies a broadening of the scope for AML obligations, marking the first time ERAs have been explicitly included under such regulatory requirements.

The Proposed Rules are carefully crafted to apply differently to specific kinds of investment advisors and advisory services. The broadened scope of the Proposed Rules makes it imperative for stakeholders to submit any and all commentary before the deadline for feedback has passed. As mentioned above, feedback on the proposed rulemaking must be submitted by April 15, 2024. Once finalized, covered investment advisors will have a 12-month window from the Proposed Rules' effective date to ensure full compliance.

The key requirement in the Proposed Rules is the requirement that RIAs and ERAs create and maintain AML programs and report suspicious activity to FinCEN. If this sounds like something that investment advisors should not have to do, that reaction is understandable. After all, investment advisors – RIAs and ERAs – are not defined as "financial institutions" in the rules that implement the Bank Secrecy Act ("BSA").[1] And for that reason, such investment advisors have not historically been required to file currency transaction reports or maintain records of funds transmittals.

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1 It is important to note that the BSA, as amended by the USA PATRIOT Act ("PATRIOT ACT"), requires all "financial institutions" to establish and maintain robust AML compliance programs. Such programs must include the development of internal policies, procedures and controls designed to thwart money-laundering activities, along with the designation of a compliance officer and ongoing employee training to assist in financial institutions' AML efforts. Currently, the definition of "financial institution" is limited to certain financial businesses, including broker-dealers, banks, and mutual funds. Yet RIAs and ERAs have never been considered financial institutions under the PATRIOT Act, and for that reason many stakeholders may be surprised at FinCEN's proposal to subject these advisers to the same compliance obligations borne by broker-dealers, banks, and mutual funds.

Under the Proposed Rules, all this would change. RIAs and ERAs would be defined as financial institutions for BSA purposes. This would in turn require those investment advisors to establish AML programs, report suspicious activities (through the filing of Suspicious Activity Reports, or "SARs"), and keep robust records of funds transmittal transactions.

KEY ELEMENTS OF THE PROPOSED REGULATORY CHANGES

RIAs and ERAs should pay particular attention to the new proposed requirements. Unlike previous proposals that did not culminate in final regulations, this initiative seems set to introduce AML/CTF obligations for both RIAs and ERAs. The U.S. Department of the Treasury has conducted thorough risk assessments to support the adoption of these rules, the findings of which have been shared with the notice of proposed rulemaking ("NPRM").[2]

If the Proposed Rules are finalized in their current form, RIAs and ERAs will need to take the following steps to create a meaningful compliance program:

1. **Review of Advisory Services and Clientele**: RIAs and ERAs should evaluate the advisory services they offer and the characteristics of their clientele to spot potential vulnerabilities to AML/CTF risks.
2. **AML/CTF Program**: Based on this evaluation, they will need to formulate policies, procedures, and internal controls tailored to manage such risks effectively. Because these policies, procedures, and internal controls are not required today, RIAs and ERAs will need to factor in compliance costs into their business models.
3. **Identification and Reporting of Suspicious Activities**: RIAs and ERAs will need to assess their own investors and investment transactions with greater diligence for the following reasons:

    a. The expectation for identifying and reporting suspicious activities goes beyond merely spotting money laundering attempts; and

    b. FinCEN has highlighted areas such as investment fraud and the risk posed by foreign investors gaining access to sensitive technology through investments as legitimate justifications for filing SARs.

NEW AML PROGRAM OBLIGATIONS

RIAs that hold dual registrations as investment advisers and broker-dealers will be allowed to operate under a singular, comprehensive AML program that addresses both advisory and broker-dealer operations, eliminating the need for separate programs. Likewise, if a covered investment adviser is linked to, or is a part of, an organization already mandated to have an AML program, it can adopt a unified AML strategy that encompasses all activities falling under the Bank Secrecy Act ("BSA") and its regulations.

Such advisers are obliged to develop a written AML policy specifically designed to prevent their services from

2 See: *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.gov.*

being exploited for money laundering and terrorist financing purposes. This policy must ensure adherence to the BSA and its regulations, and it must also be tailored to the unique risks associated with the adviser's client base and service offerings. Notably, the proposed regulations exempt advisory activities related to mutual funds with compliant AML/CFT programs, although FinCEN is considering public feedback on whether mutual funds should fall within an adviser's AML/CFT responsibilities.

The proposed rules do not differentiate between primary advisers and subadvisers, leaving unanswered how these new requirements apply to subadvisory roles. FinCEN is seeking input on how to integrate subadvisory and specific advisory services, especially those not handling client assets, within the final regulation framework.

Each covered investment adviser must designate an individual or team to oversee and ensure the efficacy of the program's operations and controls. The proposed rule also mandates training, independent audits, and written approval of the program by the adviser's governing body, or in its absence, by a sole proprietor or equivalent authority. Finally, covered investment advisers must provide full access to ALM program documentation upon the request of FinCEN or the SEC.

DO THE PROPOSED RULES REQUIRE CIP OR CDD PROGRAMS?

The proposed rule does not mandate a Customer Identification Program ("CIP") or Customer Due Diligence ("CDD") requirements akin to those imposed on certain other securities-related financial institutions. Nevertheless, it emphasizes the importance of client risk assessments as a central element of anti-money laundering efforts, with an expectation for ongoing customer due diligence.

FinCEN plans to tackle the specifics of CIP and additional AML obligations in future regulatory updates, intending to address CIP in collaboration with the SEC. For advisers working with private funds, the rule leaves ambiguous whether the fund itself or its investors constitute the client. Instead, it proposes a risk-based approach to evaluating the potential money laundering threats associated with investors in these vehicles. If the Proposed Rules are finalized in their current form, covered advisers will have to employ a risk-based approach that that treats the investors as the client.

In anticipation of more detailed CIP and CDD requirements, covered investment advisers should start contemplating the integration of such measures into their broader AML frameworks. While explicit CIP/CDD rules have yet to be established, advisers are expected to proactively evaluate the AML/CFT risks clients may pose, considering various proxies for risk. This includes, for individuals, scrutinizing the origin of their funds and their geographic location. For entities, considerations should include the nature of the business, its location, and the regulatory landscape governing it. Advisors should also factor in their historical relationship with the client and any insights from other financial institutions. Continuous due diligence on clients will be a necessity.

WHAT IS THE NEW DEFINITION OF "FINANCIAL INSTITUTION"?

The proposed regulation intends to expand the definition of "investment adviser" to encompass any individual or entity that is either registered or obligated to register with the SEC under Section 203 of the Investment Advisers Act of 1940 (referred to as "RIAs"), as well as those currently exempt from such registration under Section 203(l) or 203(m) of the same act (identified as "ERAs").

Investment advisers must carefully review this extended definition within the context of financial institution classification to ascertain their applicability under the rule, as it does not universally apply to all investment advisers, specifically excluding those registered at the state level.

Under this proposed rule, ERAs advising only private funds with assets under management below $150 million in the U.S., as well as advisers solely to venture capital funds, would be designated as financial institutions, thereby subjecting them to AML program mandates.

Additionally, the rule aims to bring certain non-U.S. investment advisers under its purview. This includes those without a physical presence in the U.S. (no branches, offices, or staff within the country) but who are either registered or mandated to register with the SEC as RIAs, or those required to file Form ADV as ERAs.

CURRENCY TRANSACTION REPORTING AND RELATED OBLIGATIONS

The proposed regulation mandates that covered investment advisers submit currency transaction reports ("CTRs") for any transactions that involve the movement of more than $10,000 in currency in a single business day, whether the transaction is initiated by, processed through, or directed to the investment adviser.

Additionally, the BSA enforces specific recordkeeping and information-sharing requirements on financial institutions for fund transfers amounting to $3,000 or more, known as the Recordkeeping and Travel Rules.

According to the proposed rule, covered investment advisers are required to maintain detailed records for each fund transfer of $3,000 or above. This documentation must include information akin to what is typically necessary for a Customer Identification Program ("CIP"), and ensure that essential details accompany the fund transfer to the next institution in the payment sequence.

Covered investment advisers are encouraged to provide feedback on these new stipulations, as FinCEN has solicited additional insights on the mechanics of money transfers within the structure of investment advisory services.

NEW SUSPICIOUS ACTIVITY REPORTING AND MONITORING OBLIGATIONS

The proposed regulation mandates that covered investment advisers must report any transaction if: (1) it is carried out or attempted by, through, or with the investment adviser; (2) it involves or cumulatively involves funds or other assets valued at $5,000 or more; and (3) the investment adviser is aware, suspects, or has

grounds to suspect that the transaction (or a series of related transactions of which the transaction is part):

A. Is linked to proceeds from illegal activities or aims to conceal or disguise assets derived from illegal activities as part of an effort to contravene or circumvent any federal law or regulation, or to sidestep any transaction reporting obligations under federal law or regulation;

B. Is structured or otherwise organized to bypass the requirements of the Bank Secrecy Act (BSA) or its implementing regulations;

C. Lacks a legitimate business or lawful purpose, or is not the type of transaction that the client would typically undertake, and the investment adviser can find no reasonable explanation for the transaction after reviewing the available information, including the background and potential purpose of the transactio; or

D. Utilizes the investment adviser to support or facilitate criminal activities (for example, fraud or financing of terrorism).

In addition to the aforementioned compliance obligations, covered investment advisers must also assess client activities and relationships to develop a monitoring program for suspicious transactions, tailored to their specific risks of money laundering. Certain activities, such as the use of money orders or travelers' checks in specific amounts to purchase private fund shares, or funding a managed account through numerous wire transfers from various accounts across different financial institutions, may signal attempts at structuring to evade currency reporting mandates.

It's critical to recognize that under the Proposed Rules suspicious activities extend beyond mere financial transactions. Covered investment advisers need to be vigilant in adhering to the proposed guidelines for identifying and reporting any suspicious behaviors.

NEXT STEPS FOR RIAS AND ERAS

Covered investment advisers should closely examine the proposed rule to pinpoint areas where they can offer feedback. FinCEN is inviting comments on numerous aspects relevant to investment adviser operations, including subadvisory roles, third-party administration, and the movement of funds, to name a few. Particularly, FinCEN is questioning if ERAs should fall under the umbrella of covered investment advisers in terms of AML programming requirements. With the deadline for comments looming, identifying additional opportunities for FinCEN to harmonize with industry practices becomes crucial. This effort aims to ease the compliance burden without undermining the fight against money laundering and terrorist financing.

In addition, RIAs and ERAs that have already implemented AML programs should be aware that under the Proposed Rules it is not sufficient to delegate AML compliance to third-parties generally, nor is it acceptable to obtain a "certification" from a third-party vendor to evidence full compliance with the Proposed Rules. Of

course, RIAs and ERAs are permitted to delegate compliance operations to third-party vendors. However, RIAs and ERAs may not establish that they are in full compliance by relying on the attestations of third-party AML vendors. As a consequence, RIAs and ERAs who already have AML compliance programs up and running will still need to carefully revisit their implementation to ensure that those programs are consistent with FinCEN's new regulatory requirements.

You've just explored our insights on the latest FinCEN regulatory developments and might be wondering about the next steps. Navigating compliance and regulatory changes can be daunting, but you're not alone. At BurgherGray, we specialize in demystifying complex regulations and helping our clients not just meet but exceed compliance standards. **Reach out to BurgherGray** for personalized assistance in understanding the new rules, structuring your compliance with FinCEN's regulatory requirements.

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