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INVESTMENT ADVISERS

FinCEN's Proposed AML Program & Reporting Requirement Rules



BY ZACHARY BREZ, MARCUS THOMPSON, MICHAEL CASEY AND SEAN SEELINGER

I. Overview

On August 25, 2015, the Financial Crimes Enforcement Network (“FinCEN”), a bureau of the United States Department of the Treasury focused on combating money laundering, terrorist financing, and other financial crimes, published a proposed rule that would apply to “any person who is registered or required to be registered with the [Securities and Exchange Commission (“SEC”)] under section 203 of the Investment Advisers Act of 1940” (collectively, “Investment Advisers”), which includes a number of U.S. private equity fund managers.¹ If finalized, Investment Advisers would be treated as “financial institutions” under the Bank Secrecy Act (“BSA”), and, for the first time, would be required to:

- Establish anti-money laundering compliance programs (“AML Programs”);

¹ All but the very smallest U.S. private equity fund managers already qualify as Investment Advisers as a result of the registration requirement contained in the Dodd-Frank Act. Under Dodd-Frank, most private equity fund managers with more than \$150 million of assets under management are required to register with the SEC.

- File suspicious activity reports (“SARs”) with FinCEN; and

- Comply with other mandatory reporting and information-sharing requirements.

These changes would bring Investment Advisers in line with a variety of banks, mutual funds, and securities broker-dealers that already have to comply with a fairly strict AML compliance regime. As proposed, the rule would apply to funds or investment vehicles organized in foreign jurisdictions, even those only offered to foreign investors, if those funds were managed by a registered private equity fund manager.

II. Background

The proposed rule is not unprecedented. FinCEN first proposed extending the requirements of the BSA regime to Investment Advisers in 2003. While that proposed rule was withdrawn in 2008, for many years there has been speculation that FinCEN would attempt to revive the proposal through a new Notice of Proposed Rulemaking. With increased global attention on money laundering and terrorist financing activities, it is not surprising that FinCEN is moving forward with this proposed rule now. This is especially true because similar requirements already exist for private equity fund managers located in other jurisdictions. For example, registered investment advisers in the United Kingdom are subject to the anti-money laundering legislation and the Third Money Laundering Directive in the European

Union, as well as the Proceeds of Crime Act in the United Kingdom.

III. Substantive Requirement

If finalized, the proposed rule would impose a series of new affirmative obligations on Investment Advisers related to anti-money laundering compliance. Each of the new requirements is described separately.

A. Creation of AML Program

Under the proposed rule, Investment Advisers would be required to establish and maintain an AML Program “reasonably designed to prevent the investment adviser from being used for money laundering or the financing of terrorist activities” and to ensure compliance with AML-related reporting and recordkeeping requirements. The specific requirements of the proposed rule comprise:

1. Policies, Procedures & Internal Controls: Investment Advisers would be required to establish and implement policies, procedures, and internal controls that are “reasonably designed” to prevent money laundering or terrorist financing that uses the Investment Advisers and related investments as a conduit. Guidance issued by FinCEN makes clear that the Agency intends for Investment Advisers to implement policies, procedures, and internal controls that are tailored to Investment Advisers’ businesses. In developing such policies, procedures, and internal controls, an Investment Adviser should consider “the types of advisory services it provides” and “the nature of the clients it advises.” The program must be memorialized in writing and approved by the Investment Adviser’s Board of Directors (or, in the absence of a Board, persons performing similar corporate functions).

2. Appointment of an AML Officer: Investment Advisers would be obligated to designate a person or persons with responsibility for implementing, monitoring, and enforcing the AML Program. The responsible individual(s) must be “knowledgeable and competent” regarding money laundering risk and the FinCEN requirements and “should” be an officer of the Investment Adviser. The proposed rule does not require such individual(s) to be exclusively dedicated to the AML Program.

3. Independent Testing: Investment Advisers would need to establish a periodic, independent testing program to ensure that their AML Program complies with applicable regulations and is effectively designed. Such testing may be conducted by a third party or an Investment Adviser’s own employees, so long as they are independent from the daily operation or oversight of the program.

4. Ongoing Training: Finally, Investment Advisers would be required to provide periodic training to employees, as well as relevant agents and third-party service providers, that is “relevant to their functions” and that helps them “recogniz[e] possible signs of money laundering that could arise in the course of duties.” The nature, scope, and frequency of such training is not articulated with the proposed rules but should instead be established on a risk basis.

B. Suspicious Activity Reporting Requirements

The proposed rule would also require Investment Advisers to file, for the first time under U.S. regulations, SARs with FinCEN. Historically, Investment Advisers

have been excluded from the requirement to make these filings imposed on “financial institutions” within the meaning of the BSA. The proposed rule would extend the same SAR reporting requirements to Investment Advisers. More specifically, Investment Advisers would be required to file a SAR for any transaction conducted or attempted “by, through, or at” the Investment Adviser that involves or aggregates funds or other assets of at least \$5,000 and:

1. “Involves funds derived from illegal activity or is intended or conducted to hide or disguise funds or assets derived from illegal activity”;

2. “Is designed, whether through structuring or other means, to evade the requirements of the BSA”;

3. “Has no business or apparent lawful purpose, and the investment adviser knows of no reasonable explanation for the transaction after examining the available facts”;

4. “Involves use of the investment adviser to facilitate criminal activity.”

The criteria contain a degree of ambiguity and must take into account the totality of facts and circumstances. After learning of such activity, the Investment Adviser is obligated to file a SAR within 30 days. Furthermore, an Investment Adviser would be obligated to maintain the confidentiality of the SAR and any related information, including from the subject of the SAR. As proposed, the SAR would also need to be kept confidential within the Investment Adviser’s corporate structure. Upon timely and compliant filing of a SAR, the Investment Adviser would be afforded statutory safe harbour protections under the BSA.

Under the rule, Investment Advisers may delegate AML Program requirements, including SAR filing responsibilities, to an agent or third-party processor. The Investment Adviser, however, would still remain responsible for exercising adequate oversight over the third party.

C. Additional Collection and Reporting Requirements

Under the proposed rule, Investment Advisers would be included within the definition of “financial institutions,” and, as a result, would be subject to certain reporting and information-sharing requirements pursuant to the BSA. Principle requirements include:

1. Filing of Currency Transaction Reports (“CTRs”): An Investment Adviser would have to file CTRs with FinCEN regarding currency transactions exceeding \$10,000 by or on behalf of the same person on the same day by, to, or through the Investment Adviser. It is unlikely that this will have a meaningful effect on private equity fund managers who are unlikely to deal in currency transactions.

2. Transfer & Travel Rule Recording Requirements: Investment Advisers would be required to maintain records of any transaction where funds of \$3,000 or more are sent or received by the Investment Adviser. Investment Advisers would also need to ensure information regarding such transaction “travels” to the next financial institution within the payment chain.

3. Information-Sharing Requirements: Investment Advisers would be subject to information sharing requirements under the BSA regime. These include the periodic review of FinCEN lists of persons suspected of involvement in money laundering and terrorist financing. The results of such reviews must be reported to

FinCEN via a secured network. Furthermore, under the BSA, an Investment Adviser would have the option of registering with FinCEN to participate in the sharing of information with other financial institutions subject to regulations regarding its AML Program. Financial Institutions participating in the program have the option to make and receive information requests from other financial institutions on a limited basis to determine whether to file a SAR and are protected by a safe harbour from civil liability to a customer for information sharing.

It is important to note that the proposed rule would not require Investment Advisers to implement a customer identification program.

D. Timeline

FinCEN officially published its Notice of Proposed Rulemaking on September 1. Public comments were due sixty days later on November 2. If FinCEN moves forward with the rule, the final rule would likely be published at some point in 2016. FinCEN has proposed a six-month delayed effective date from the date of the issuance of the final rulemaking for compliance with the requirement to implement an AML Program.

IV. Implications for Private Equity Firms

The proposed rules would effectively bring U.S. regulation of private equity fund managers closer in line with existing requirements in other parts of the world such as the United Kingdom, where funds and managers have long been classified as members of the “regulated sector” for money laundering purposes, alongside traditional financial institutions such as banks, and service providers such as lawyers and accountants. This classification requires private equity fund managers to maintain an AML Program and file SARs. The United Kingdom’s Financial Conduct Authority has focused on AML compliance in recent years, conducting a Thematic Review in 2013 to identify weaknesses within the financial industry in combatting money laundering, bribery, and corruption. The Review identified good and bad practices against which firms could compare their programs.

Consequently, private equity fund managers with a jurisdictional nexus to the United Kingdom may find FinCEN’s proposed rules to be less burdensome as they likely have already developed an AML Program and implemented internal controls to detect and report suspicious activities due to U.K. regulatory requirements. Other private equity fund managers are likely to have implemented an AML Program as part of voluntary governance and risk mitigation strategies. Indeed, FinCEN noted that it expects many Investment Advisers could adapt existing AML policies to comply with the proposed rules. Nevertheless, funds must still go through a comprehensive evaluation process to ensure full compliance with the specific requirements contained in the proposed rules and promptly make and implement the changes necessary in order to ensure full compliance.

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Some private equity fund managers will need to dedicate substantial attention to developing an AML Program and internal control framework to satisfy reporting requirements. For newly registered firms, this burden comes on top of the need to comply with other registration requirements and prepare for presence exams. FinCEN did, however, cite existing obligations under the Advisers Act to maintain certain books and records, adopt written policies and procedures reasonably designed to prevent violation of the Advisers Act, designate a chief compliance officer, and conduct annual compliance program reviews that should help Investment Advisers satisfy the proposed rules’ AML requirements.

VI. ENFORCEMENT

If adopted, FinCEN would delegate its examination authority to the SEC. The SEC’s Office of Compliance Inspections and Examinations takes a risk-based approach to examining registered entities, including Investment Advisers, to improve compliance, prevent fraud, monitor risk, and inform policy. Examinations, which may be announced or unannounced, begin with a request for documents and information and often involve an on-site review and interviews with Investment Adviser staff. FinCEN, however, would remain the regulator for the purpose of SAR filings, amongst other things.

If adopted, once the final rules are effective, an Investment Adviser with a deficient AML Program, or in violation of reporting and information sharing requirements, may be at risk for civil or criminal liability. FinCEN and the Department of Justice have previously brought enforcement actions against “financial institutions” for failing to maintain adequate AML Programs under the BSA. Under the proposed rule, similar enforcement actions could be brought against Investment Advisers. Furthermore, while the proposed rule does not articulate whether the AML Officer could be held individually liable for failures overseeing the AML Program, FinCEN and other federal regulators have sought to hold officers and directors individually liable for violations of the BSA.

VII. CONCLUSION

Given FinCEN’s renewed focus on imposing affirmative anti-money-laundering requirements on Investment Advisers, it seems likely that the agency will follow its recently published proposed rule with a final rule in 2016. Firms, especially those without robust AML Programs, should commence preparations to comply with these increased regulatory requirements now by conducting a risk assessment and a review of existing compliance programs and internal controls against the requirements contained in the proposed rules.

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Zachary Brez is co-head of Ropes & Gray's securities & futures enforcement and business & securities litigation practices. He works with clients to investigate, mitigate, and advise about their most pressing enforcement, regulatory, and litigation matters.

Marcus Thompson is a partner in Ropes & Gray's government enforcement practice group. He assists clients with a variety of business-related criminal matters such as anti-money laundering, anti-bribery and corruption, international sanctions and corporate investi-

gations. He has significant experience advising companies on the design and implementation of compliance programs and has worked on such programs in many countries around the world.

Michael Casey is counsel in Ropes & Gray's government enforcement practice. Mike focuses his practice on representing clients in investigations, transactions, and regulatory matters related to economic sanctions, export controls, money laundering, international corruption, customs, and the CFIUS review process.

Sean Seelinger is an associate in Ropes & Gray's government enforcement practice.