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FinCEN Proposes Rule Requiring Investment Advisers to Establish Anti-Money Laundering Programs

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On February 13, 2024, the US Department of the Treasury's Financial Crimes Enforcement Network (FinCEN) **issued a notice of proposed rulemaking** that would expressly include certain investment advisers in the definition of a "financial institution" under the Bank Secrecy Act (BSA) and its implementing regulations, which collectively establish the US anti-money laundering (AML) and counter-terrorism financing (CFT) regime. The proposal would subject covered investment advisers to AML/CFT requirements – including implementing and maintaining a risk-based AML/CFT program, reporting suspicious activity to FinCEN, and meeting recordkeeping requirements. FinCEN would have the authority to seek civil penalties for noncompliance.

FinCEN states in the press release that the proposed rule is part of a larger effort by the agency to combat illicit finance risks and add transparency to the US financial systems. For example, FinCEN recently issued a proposed rule requiring increased reporting around all-cash real estate transactions. Additionally, FinCEN's beneficial ownership information (BOI) reporting rule, which implements the **Corporate Transparency Act** (CTA), took effect on January 1, 2024, requiring nonexempt companies created or registered in the US to submit BOI reports to FinCEN.

According to FinCEN Director Andrea Gacki, the goal of the proposed rule is to prevent criminals and foreign adversaries from exploiting the US financial system through investment advisers, which oversee tens of trillions of dollars. The proposal revisits the substance of a 2015 notice of proposed rulemaking that similarly would have extended AML/CFT requirements to investment advisers.

The deadline to submit comments on the proposed rule is April 15, 2024.

Which entities are covered?

The **proposed rule** would revise the definition of a "financial institution" under the BSA's implementing regulations to include the following two types of investment advisers.

1. Investment advisers registered with the Securities and Exchange Commission (SEC), also known as registered investment advisers (RIAs).
2. Investment advisers that report to the SEC as exempt reporting advisers (ERAs).

Under the proposed rule, the definition of an investment adviser would exclude state-registered investment advisers and non-US investment advisers that rely on the foreign private adviser exemption.

While the statutory BSA provisions do not include investment advisers in the definition of a financial institution, FinCEN has the authority to add businesses that engage in any activity "similar to, related to, or a substitute for" activities in which any of the enumerated financial institutions are authorized to engage. FinCEN states in the commentary to the proposed rule that the asset management services provided by investment advisers are similar to or a substitute for those offered by other financial institutions

already covered under the BSA, including broker-dealers, banks and insurance companies.

The proposed rule

AML/CFT requirements

The proposed rule would require that covered investment advisers comply with certain AML/CFT requirements, including the following:

1. Implement a risk-based AML/CFT program. Investment advisers covered by the proposed rule would be required to implement a reasonably designed risk-based AML/CFT program to combat money laundering and the financing of terrorism through the institution. The AML/CFT program requirement would not be a one-size-fits-all solution, but rather the individual investment adviser's program would need to be commensurate with the adviser's specific risks, services and customer base.

As proposed, the AML/CFT program would be required to include, at a minimum, the following:

- The development of internal policies, procedures and controls.
- The designation of a person or persons responsible for implementing and monitoring the operations and internal controls of the program (e.g., a compliance officer).
- Risk-based procedures for ongoing customer due diligence (CDD).
- Risk-based procedures to understand the nature and purpose of customer relationships to develop customer risk profiles.
- An ongoing employee training program.
- An independent audit function to test programs.

FinCEN also expects investment advisers to maintain sufficient oversight of third-party service providers. The proposed rule would require an investment adviser's board of directors (or a similar body) to approve the AML/CFT program.

For investment advisers dually categorized as other financial institutions (e.g., banks and broker-dealers), there would be no requirement for separate AML/CFT programs to be established for each line of business. Rather, in these instances, there should be a comprehensive AML/CFT program that covers all of the entity's business and activities that are subject to BSA requirements.

2. Submit suspicious activity reports (SARs). Investment advisers would be required to submit SARs, replacing the joint FinCEN/Internal Revenue Service Form 8300 that investment advisers currently use to report suspicious activity. Reportable suspicious transactions would be those 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. Investment advisers would still be required to comply with all other reporting requirements imposed by the SEC.

SARs would be required to be kept confidential and submitted within 30 days of identifying acts that may be the basis of the suspicious activity. According to the commentary on the proposed rule, identifying suspicious activity would be fact-specific, but could include activities such as potential fraud, manipulation of customer funds directed by the investment adviser, insider trading, market manipulation, transferring funds or assets involving third parties with no plausible relationship to the customer, or unusual wire transfer requests.

3. Recordkeeping and reporting. Under the proposed rule, investment advisers would be required to comply with existing recordkeeping requirements under the BSA, including the "Travel Rule," to the extent applicable. The Travel Rule (31 CFR 1010.410(e),(f)) requires financial institutions to create and retain records for fund transmittals that equal or exceed $3,000 and

include certain information (e.g., sender's name and address, transaction information, and sender's financial institution) with the transmittal order so that it "travels" to the next financial institution in the payment chain. In at least some cases, transactions processed by investment advisers may be excluded from Travel Rule requirements, based on the definition of a covered "transmittal of funds" and the exemption for transfers between certain financial institutions. Investment advisers also would be required to create and retain records for extensions of credit and cross-border transfers of currency, monetary instruments, checks, investment securities and credit.

Additionally, under FinCEN's regulations, investment advisers are currently required to report transactions involving the receipt of more than $10,000 in cash and negotiable instruments using Form 8300. Under the proposed rule, investment advisers would still have the obligation to report such transactions, but would be required to submit reports for transactions involving a transfer of more than $10,000 in currency by, through or to the investment adviser, unless subject to an applicable exemption, and submit relevant information using currency transaction reports (CTRs), as required under the BSA, instead of using Form 8300.

Other obligations and considerations

Investment advisers also would be required to implement risk-based procedures for customer due diligence pursuant to the Customer Due Diligence (CDD) Rule for covered financial institutions (currently banks, mutual funds, brokers or dealers in securities, futures commission merchants and introducing brokers in commodities). The CDD Rule requires covered financial institutions to identify and verify the beneficial owners of legal entity customers as part of the covered entity's customer identification program (CIP). The CDD Rule is currently subject to modification in connection with the recent implementation of the BOI Rule and, therefore, FinCEN is not proposing to impose the same CDD Rule on investment advisers that currently applies to banks and other covered financial institutions. Instead, FinCEN is taking a partial step toward doing so by including investment advisers in the definition of "covered financial institutions" under 31 CFR 1010.605(e)(1) for purposes of the CDD Rule. But, because the applicability of the CDD Rule is predicated on a financial institution having express CIP obligations, the CDD Rule will not – at least initially – be operationalized with respect to investment advisers.

To begin with, therefore, investment advisers would be required to establish AML programs that include risk-based customer due diligence procedures that include, but are not limited to, understanding the nature and purpose of customer relationships for the purpose of developing a customer risk profile, as well as conducting ongoing monitoring to identify and report suspicious transactions and – on a risk basis – to maintain and update customer information. However, the proposed rule would not impose a CIP requirement or, in turn, express requirements to obtain BOI. FinCEN will instead collaborate with the SEC to develop such CIP and beneficial owner requirements, which also will be informed by future CDD rulemakings under the CTA and its implementing regulations.

Finally, to avoid redundancy under the proposed rule, investment advisers would not be required to apply AML/CFT program or SAR filing requirements to the mutual funds they advise. Mutual funds are currently included in the definition of a financial institution and therefore have their own similar obligations under the BSA.

SEC's examination authority

As part of the proposal, FinCEN seeks to delegate examination authority for the rule to the SEC, given the SEC's expertise with investment advisers and experience in examining other financial institutions with AML responsibilities and requirements. FinCEN currently delegates to the SEC the authority to examine mutual funds, as well as brokers and dealers in securities, for compliance with the BSA. Still, FinCEN retains its rulemaking and enforcement authorities in its administration of AML/CFT rules and requirements applicable to investment advisers.

Next steps

Under the proposed rule, covered investment advisers would be required to comply with the rule on or before 12 months from the final rule's effective date. Investment advisers should review the rule to assess the potential impact and may wish to consider providing comments to FinCEN by the April 15 deadline.

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