Client Update
FinCEN Proposes Anti-Money Laundering Rules for Investment Advisers

WASHINGTON, D.C.
Kenneth J. Berman
kjberman@debevoise.com

Satish M. Kini
smkini@debevoise.com

Robert T. Dura
rdura@debevoise.com

Gregory T. Larkin
gtlarkin@debevoise.com

NEW YORK
Michael P. Harrell
mpharrell@debevoise.com

Lee A. Schneider
lschneider@debevoise.com

David G. Sewell
dgsewell@debevoise.com

HONG KONG
Andrew M. Ostrognai
amostrognai@debevoise.com

LONDON
Matthew Howard Getz
mgetz@debevoise.com

On August 25, 2015, the U.S. Treasury Department's Financial Crimes Enforcement Network ("FinCEN") proposed new regulations (the "Proposed Rules") that would extend mandatory anti-money laundering ("AML") requirements to all investment advisers registered or required to be registered with the Securities and Exchange Commission ("SEC") under the Investment Advisers Act of 1940 (the "Advisers Act"). The deadline for providing comments on the Proposed Rules is 60 days after the Proposed Rules are published in the Federal Register.

The Proposed Rules would, among other things, require investment advisers to:

- Develop and implement written AML programs;
- Put in place policies and procedures to detect and report suspicious activities to U.S. authorities; and
- Comply with mandatory information-sharing requirements, including responding to law enforcement inquiries under the USA PATRIOT Act.

Compliance with the Proposed Rules would be assessed by the SEC through the examination process. Once final rules are adopted, an adviser with deficient AML policies, procedures and controls may be at risk for civil or criminal liability.

An investment adviser's AML program would need to be tailored to the specific risks posed by the advisory services it provides and the clients it advises. FinCEN specifically recognizes that private funds posing lower risks for money laundering would be risk-rated differently than higher risk funds.

Many investment advisers, including private equity fund managers, currently have AML policies and procedures. They should begin to consider whether the Proposed Rules will require enhancements or changes to these policies and procedures.

WHO IS COVERED BY THE PROPOSED RULES?

The Proposed Rules would apply, without exception, to the more than 11,000 investment advisers currently registered with the SEC. However, FinCEN has requested comment on whether certain advisers, particularly those posing very low money laundering risks, should be excluded from the rules.

FinCEN does not propose to apply these rules to exempt reporting advisers or foreign private advisers at this time, but it did request comments about whether these advisers should be covered by future rulemakings.

In previous proposed rulemakings, issued in the early 2000s and subsequently withdrawn, FinCEN provided exclusions from its AML regulations for certain advisers and funds it considered low risk from a money laundering perspective, such as many private equity funds and their advisers. Although FinCEN recognizes in the present rulemaking that different types of advisers may face different degrees of money laundering risks (and acknowledges that compliance obligations can be calibrated to account for risk), the previous exclusions have not been incorporated into the Proposed Rules.

WHAT ARE THE REQUIREMENTS FOR AN AML PROGRAM?

Under the Proposed Rules, an investment adviser would be required to design and implement 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 AML program would need to be in writing and approved by the investment adviser's board of directors or, if it lacks a board, persons performing similar corporate functions.

To meet the "reasonably designed" requirement, an investment adviser's AML program would need to be tailored to the specific risks posed by the advisory services it provides and the clients it advises. For example, regarding private funds, FinCEN generally expects the adviser to have "access to information" regarding the identities and transactions of the funds' investors. FinCEN notes that, in some circumstances, "there may be a lack of transparency regarding the entities that invest in private funds" and, consequently, an investment adviser may be required to assess on a risk-based basis the money laundering risks associated with the underlying investors of a private fund. FinCEN specifically recognizes that private funds posing lower risks for money laundering would be risk rated differently than higher-risk funds.

The Proposed Rules would mandate, at a minimum, four required elements for an investment adviser's AML program. Although each element would need to be present, the manner in which the program is implemented would be determined by the investment adviser's risk assessment:

- *Internal Controls.* An investment adviser would be required to establish and implement policies, procedures and internal controls reasonably designed to ensure compliance with the Proposed Rules and prevent money laundering or terrorist financing through the investment adviser.
- *Independent Testing.* The AML program must provide for periodic independent testing to assess compliance with the Proposed Rules. Testing may be conducted by a third party or the investment adviser's or its affiliates' employees, provided that such employees are not involved in the operation and oversight of the investment adviser's AML program. The proposal indicates that the frequency of testing would be dependent on the investment adviser's money laundering and terrorist financing risk assessment.
- *AML Officer.* The investment adviser must designate an individual or a committee to be responsible for implementing and monitoring the AML program. The AML Officer is expected to be knowledgeable and competent regarding the investment adviser's money laundering risks and AML obligations and is expected to have full responsibility and authority to develop and enforce appropriate policies and procedures to address the money laundering risks faced by the investment adviser. Whether the AML Officer is dedicated full-time to overseeing the AML program should be determined by the size and types of advisory services the adviser provides and the clients it serves.
- *Ongoing Training.* The AML program must provide for the training of appropriate employees and relevant agents and third-party service providers. The training should cover the investment adviser's AML obligations generally, as well as provide tailored, job-specific guidance that, among other goals, assists the employee in recognizing possible "red flags" indicative of money laundering or terrorist financing. Training should be provided concurrently with an employee's assumption of duties related to the AML program, and relevant employees should receive periodic training to provide updates and refreshers regarding the investment adviser's AML program. Training can be provided in a variety of formats, including live training seminars and computer-based training.

FinCEN acknowledges that investment advisers may be able "to adapt existing policies, procedures, and internal controls to comply with" these requirements.

For example, FinCEN cited 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 reviews as potentially helpful in meeting the Proposed Rules' AML requirements.

WHAT ARE THE REQUIREMENTS FOR REPORTING SUSPICIOUS TRANSACTIONS TO THE GOVERNMENT?

The Proposed Rules would impose, for the first time, a requirement that investment advisers report certain suspicious activities to U.S. authorities.

Under the Proposed Rules, an investment adviser must file a suspicious activity report ("SAR") with FinCEN if:

- A transaction is conducted or attempted by, at or through the investment adviser;
- Involves or aggregates funds or other assets of at least $5,000; and
- The investment adviser knows, suspects or has reason to suspect that the transaction (or a pattern of transactions of which the transaction is part):
  - Involves money laundering (funds that are derived from illegal activity or the transaction is intended to hide or disguise funds or assets derived from illegal activity);
  - Is designed to evade FinCEN's regulations, including recordkeeping or reporting requirements;
  - Has no business or apparent lawful purpose or is not the sort in which the particular customer would normally be expected to engage, and the investment adviser knows of no reasonable explanation for the transaction after examining the available facts; or
  - Involves use of the investment adviser to facilitate criminal activity.

A SAR generally would need to be filed within 30 days after an investment adviser becomes aware of a suspicious transaction.

In the case of either a voluntary or mandatory report, the investment adviser would be afforded the full statutory safe harbor under the BSA for protection from liability for SAR filings. At the current time, there is some uncertainty as to whether voluntary SAR filings by advisers benefit from this safe harbor.

After filing with FinCEN, an investment adviser would be required to keep a copy of the SAR as well as the original, or its business record equivalent, of any documentation supporting the SAR for a period of not less than five years from the date of filing. The Proposed Rules generally would require that an investment adviser maintain the confidentiality of a SAR and any information that may reveal the existence of a SAR.

As part of its AML program, an investment adviser would need to adopt policies, procedures and internal controls to ensure that suspicious transactions are promptly identified and reported accurately. The failure to have adequate suspicious transaction monitoring processes and to file SARs on a timely basis could result in both civil liability and criminal prosecution.

Indeed, deficiencies in SAR filing procedures have been a significant enforcement issue for other financial institutions (such as banks and broker-dealers) with SAR filing obligations. Earlier this year, senior staff from the SEC's Division of Enforcement commented publicly on observed disparities in the quantity and quality of SARs filed by broker-dealers and indicated that ensuring full compliance with the SAR filing regime would be an area of enforcement focus. Advisers too will need to be ready for such regulatory scrutiny once their SAR filing requirement is finalized.

ARE THERE OTHER REQUIREMENTS UNDER THE PROPOSED RULES?

Under the Proposed Rules, investment advisers would be required to comply with many of the general reporting and recordkeeping requirements imposed by the BSA and its implementing regulations. For example, investment advisers would be required to:

- Comply with the Recordkeeping and Travel Rules that apply to the transmittal of funds by non-bank financial institutions and other recordkeeping requirements for certain extensions of credit and cross-border transfers; and
- Respond to information requests from U.S. law enforcement pursuant to the USA PATRIOT Act. These requests will require advisers to review their account and transactional records to identify any dealings that involve the person about whom law enforcement has inquired.

Again, an investment adviser would be required to have policies, procedures and controls in their AML programs to address these various requirements.

In the Proposed Rules, FinCEN signals that this rulemaking is the start of a series of new regulations aimed at bolstering investment advisers' AML obligations. FinCEN indicated in the preamble accompanying the Proposed Rules that it "anticipates" addressing specific AML-related due diligence requirements in future rulemakings, and FinCEN's rulemaking asks questions as to whether additional AML obligations that apply to other financial institutions (such as customer identification requirements and specific requirements about dealing with foreign banks) also ought to apply to investment advisers. We will keep you apprised of these developments.

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Please do not hesitate to contact us with any questions.