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FinCEN Proposes AML and SAR Filing Obligations for RIAs and ERAs

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On February 13, 2024, the United States Treasury's Financial Crimes Enforcement Network ("FinCEN") issued a proposed rule that would apply comprehensive anti-money laundering and countering the financing of terrorism ("AML/CFT") requirements to registered investment advisers ("RIAs") and exempt reporting advisers ("ERAs") and include them in the definition of financial institution under the Bank Secrecy Act ("BSA").[1] While the impact of the proposed rule will vary, if the rule comes into effect as proposed, many RIAs and ERAs likely will need to modify current AML procedures.

Overview of the Proposed Rule

Many RIAs maintain AML policies and procedures as a matter of best practice, and to support required representations to counterparties that presently are subject to FinCEN's AML/CFT requirements. Under FinCEN's proposed rule, RIAs and ERAs would be included within the definition of "financial institution" under the BSA. As a "financial institution" under the BSA, RIAs and ERAs would be subject to several new specific BSA requirements, including establishing an AML program, filing suspicious activity reports, conducting customer due diligence, and conducting enhanced due diligence on certain foreign counterparties. As these requirements are currently applicable to other "financial institutions" under the BSA such as registered broker-dealers, the compliance and regulatory framework for an RIA/ERA if the Proposed Rule, along with an expected joint rule from FinCEN and the SEC, is adopted will be akin to what currently is applicable for registered broker-dealers. Investment advisers would have 12 months from the publication date of the final rule to implement policies, procedures, and processes that address these requirements.

- *AML Program:* RIAs and ERAs would have to implement an AML program that is reasonably designed to prevent the investment adviser from facilitating money laundering. The proposal only extends to advisory services and will not cover non-advisory services performed by the investment adviser.

- *Customer Due Diligence ("CDD"):* RIAs and ERAs will be expected to conduct customer due diligence sufficient to "know their customer." This includes initial and ongoing due diligence and developing a customer risk profile.

- *Enhanced Due Diligence ("EDD"):* For relationships with foreign financial institutions, RIAs and ERA would be required to conduct enhanced due diligence. This heightened due diligence obligation for foreign financial institution relationships would carry with it a $1.7 million penalty for each willful violation.

- *Suspicious Activity Reports ("SARs"):* RIAs and ERAs would be required to report suspicious transactions or activity that aggregates to $5,000 or more. An adviser can rely on joint filings with other affiliates for activity that spans multiple financial institutions.

- *U.S. Person Responsibility:* Recognizing that foreign located advisers may be subject to the rule, FinCEN will require that RIAs and ERAs assign the responsibility to establish, maintain, and enforce the AML/CFT program to persons in the United States.

FinCEN has deferred the obligations for advisers to establish a customer identification program and collect beneficial ownership information to a likely forthcoming joint proposal from FinCEN and the SEC.

Potential Enforcement Risk on the Horizon

The Proposed Rule states that covered investment advisers would be required to develop and implement the requisite AML program within twelve (12) months of the effective date of the final rule. FinCEN proposes to delegate its examination authority under the new rule to the SEC, which is consistent with existing delegation to the SEC of the authority to examine broker-dealers and other entities for compliance with the BSA and FinCEN regulations.

The SEC has for years argued that Section 17a-2 of the Securities Exchange Act of 1934 and Rule 17a-8 thereunder provide a jurisdictional hook for the SEC to bring enforcement actions against broker-dealers for allegedly failing to file SARs. Registered brokers disagreed, but in December 2020, the Second Circuit issued a precedent-setting opinion in *SEC v. Alpine Securities Corp.*, holding that Section 17a-2 and Rule 17a-8 do endow the SEC with authority to enforce SAR filing requirements.[2] With this newly confirmed authority in hand and a Proposed Rule pending, advisers should be wary of the potential for enforcement activity by the SEC in light of the *Alpine* opinion and the fact that the SEC has already taken action against RIAs for failure to enforce existing voluntarily adopted AML policies.[3]

Short and Long-term Considerations for RIAs and ERAs

If the Proposed Rule is adopted, it is expected to require updates to investment adviser AML policies and procedures. The extent of the effect will differ depending on the type of adviser. For example, registered advisers owned or controlled by bank holding companies (BHCs) already adhere to similar requirements applied to their parent BHCs, and registered advisers dually registered as broker-dealers that would fall under the BSA likely have put in place an enterprise-wide AML program. Additionally, many advisers have implemented AML programs as a matter of best practice and to align with industry standards even though not required by law.

Even so, if the Proposed Rule is adopted, RIAs/ERAs will need to consider the following:

- Re-evaluate current AML programs to determine whether they meet the Proposed Rule.

- Review client and investor agreements to ensure they allow for the information sharing that would be necessary to implement a compliant AML program under the Proposed Rule.

- Revise outsourced AML agreements with third parties (e.g., transfer and administrative agents) to enhance their oversight of these third parties, given the higher enforcement risk and obligations for U.S. person responsibility in the rule.

Additional Consideration

Given past unsuccessful attempts to finalize money laundering rules for the investment adviser industry, it is difficult to assess when and if these Proposed Rules will be finalized. However, the progress of this proposal should be closely followed as its enactment would impose substantial new burdens on investment advisers. FinCEN has invited public comments on all aspects of the Proposed Rule but specifically seeks comment on several issues, including: (i) excluding certain advisers whose activity presents a low risk for money laundering and (ii) excluding ERAs and foreign advisers. The comment period ends on April 15, 2024.

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[1] https://www.fincen.gov/news/news-releases/fact-sheet-anti-money-laundering-program-and-suspicious-activity-report-filing; https://www.federalregister.gov/public-inspection/2024-02854/anti-money-launderingcountering-the-financing-of-terrorism-program-and-suspicious-activity-report.

[2] *SEC v. Alpine Securities Corp.*, 982 F.3d 68 (2d Cir. 2020), *cert. denied*.

[3] *See* https://www.sec.gov/files/litigation/admin/2021/ia-5762.pdf.