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BY CONWAY DODGE AND PETER BASS

Investment Advisers May Soon Face New AML Requirements

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Investment advisers registered with the Securities and Exchange Commission may soon need to comply with new regulation requiring them to carry out the kind of customer and account monitoring long demanded of banks, broker-dealers, and mutual funds.

The Treasury Department's Financial Crimes Enforcement Network may be close to issuing a final rule that would require SEC-registered investment advisers — commonly known as RIAs — to establish risk-based anti-money-laundering programs and report suspicious account activity to FinCEN under the Bank Secrecy Act. As with the existing AML framework governing broker-dealers, FinCEN intends to delegate to the SEC examination authority for advisers' compliance with the proposed requirements. The SEC has levied multimillion-dollar fines against broker-dealers over inadequate customer monitoring and failure to report suspicious activity — penalties that show the seriousness with which the commission takes AML lapses at firms it oversees.

FinCEN's rule — which was proposed in August 2015 — would generally apply to advisers that manage $100 million in assets or more and would subject them to new demands within an evolving area of compliance.[1] Financial firms in recent years have paid record-level penalties for BSA/AML violations, as banking regulators and the Justice Department — and more recently, the SEC and Financial Industry Regulatory Authority — have cracked down on lapses in controls.

"Investment advisers are on the front lines of a multi-trillion dollar sector of our financial system," FinCEN Director Jennifer Shasky Calvery suggested when FinCEN proposed the rule. "If a client is trying to move or stash dirty money, we need investment advisers to be vigilant in protecting the integrity of their sector."[2]

The rule would notably cover advisers to private funds — such as hedge and private-equity funds — and would apply regardless of an adviser's control or custody of client assets, as regulators are seeking to impose AML requirements on firms that have a view of the origin and flow of customer funds. The proposal is less broad in other ways. It would not require RIAs to establish customer-identification programs and enhanced customer due diligence, which involve identifying and verifying the identities of beneficial owners. But FinCEN has indicated it will issue additional AML rules applicable to advisers, which may later face more stringent customer-ID requirements.

FinCEN's proposal elicited comment letters reflecting the diverse perspectives of the constituencies that would feel the rule's impact. But a common observation was that the proposed rule would treat RIAs as

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1 https://www.gpo.gov/fdsys/pkg/FR-2015-09-01/pdf/2015-21318.pdf
2 https://www.fincen.gov/news_room/nr/html/20150825.html

a uniform group, when it is highly diverse in terms of money-laundering risk.[3] The comment letters are also nearly unanimous in requesting a 12- or 18-month compliance period, rather than the six months the proposal would give firms to meet its requirements. The regulator will take these comments into consideration as part of its rulemaking process. But if the rule is finalized as proposed, investment advisers will have to move quickly to establish and implement appropriate AML programs and meet related requirements.

Recent SEC and FINRA enforcement actions, as well as comments by senior SEC officials about broker-dealers, suggest the commission will pursue AML compliance aggressively in examinations and enforcement investigations — a regulatory shift investment advisers should be mindful of.

Background

FinCEN proposed AML rules for investment advisers in 2002 and for unregistered investment companies in 2003 — an earlier set of rules similar to the 2015 proposal in most respects, though the current proposal would require investment advisers to file suspicious-activity reports. The regulator withdrew the prior proposals in 2008, citing the length of time that had elapsed and the need for a new proposal. FinCEN also said at the time that — due to the major AML rulemakings it concluded since 2003 for banks, broker-dealers, and other financial institutions — AML obligations for investment advisers may not be necessary, because "their activity is not entirely outside the current BSA regulatory regime." FinCEN's current rule proposal signals a slight change in views about the money-laundering risk posed by advisory activity:

> When an adviser orders a broker-dealer to execute a trade on behalf of an adviser's client, the broker-dealer may not know the identity of the client. When a custodial bank holds assets for a private fund managed by an adviser, the custodial bank may not know the identities of the investors in the fund. Such gaps in knowledge make it possible for money launderers to evade scrutiny more effectively by operating through investment advisers rather than through broker-dealers or banks directly.

The Proposal's Major Requirements

ESTABLISHING AN AML PROGRAM

The requirement that RIAs develop and implement a comprehensive AML compliance program is a critical component of the proposed regulatory framework. This program would consist of four pillars, requiring advisers to:

1. Designate a compliance officer responsible for implementing and monitoring the program's operations and internal controls
2. Establish and implement written policies, procedures, and internal controls
3. Provide ongoing training for employees on the BSA requirements relevant to their functions
4. Provide independent compliance testing conducted by company personnel or a qualified outside party

[3] Several comments point out that private funds are often extremely illiquid, and so are poor vehicles for money laundering. Private-equity funds, in particular, typically prohibit investors from redeeming or transferring their fund interests for several years. Several of the comments argued that PE funds should be excluded entirely or partially from the rule's requirements.

Regulators have come to expect that AML programs will include testing units that have the resources and stature to operate effectively and independently, and that senior management will establish a tone from the top that encourages a compliant AML culture. The designated AML compliance officer must be highly knowledgeable about the investment adviser's money-laundering risks and FinCEN's regulatory requirements. Firms face the challenge of establishing a compliance-testing unit, independent of the lines of business, which can ensure that policies, procedures, and internal controls are being implemented properly. The person responsible for testing also needs to be truly independent — someone, like the AML compliance officer, who does not perform the functions under review. The proposed rule will generally require the compliance program to cover a firm's full advisory activity, whether the adviser acts as the primary adviser or as a subadviser. The adviser's board of directors will also need to approve the program.

Firms can meet the requirements for an AML program by identifying and assessing the specific risks they face and tailoring each aspect of the program accordingly. Advisers can begin program development by designing and conducting a thorough assessment of the AML risks posed by their business and clients and the effectiveness of the controls in place to mitigate these risks. Firms should consider all relevant factors, such as the source of client funds, the jurisdiction in which the client is located, the applicable statutory and regulatory regimes, the adviser's historical experience with the client, and references from other financial institutions. They should draw on existing control assessments — such as the results of self-testing, internal audit reports, and third-party assessments — and consider additional control assessment, as appropriate.

SUSPICIOUS-ACTIVITY REPORTING

The proposal would also require the investment adviser to report suspicious transactions within 30 days of becoming aware of them. Advisers would have to file SARs on various types of transactions: Those involving $5,000 or more that might potentially derive from illegal activity, any intended to evade legal requirements, and those that have no apparent business or otherwise lawful purpose are among the transactions that would trigger SAR obligations. Types of behavior that suggest the customer engaged the adviser for unlawful purposes — and that might require a SAR — include:

- Use of securities accounts primarily for transactions unrelated to securities (e.g., wire transfers)
- Lack of customer concern about high fees or losses in the accounts
- Customer focus that appears to be on the movement of funds
- High concentration of trading in thinly traded securities (e.g., microcap securities and penny stocks)

RECORD-KEEPING AND REPORTING OBLIGATIONS

The proposed rule would subject advisers to the BSA's general reporting and record-keeping requirements, including:

- Currency-transaction reporting of money transfers of more than $10,000 by or through the investment adviser
- Record keeping in compliance with the so-called travel rule, which requires firms to create and retain records of transmittals exceeding $3,000 and to ensure that information about the transmittal travels to the next financial institution in the payment chain
- Information sharing and responses to law-enforcement requests about accounts or transactions held by persons the government suspects of illegal activity

Heightened AML Scrutiny Spreads beyond FinCEN

AML compliance has traditionally been a focus for the banking industry. But regulators now expect a widening array of financial firms to strengthen their controls against money laundering. The SEC has recently emphasized the importance of AML compliance for firms under its jurisdiction — through letters announcing regulatory priorities, higher penalties for violations, and more intense scrutiny during routine examinations.

Money laundering will become an area of stronger SEC enforcement concern if investment advisers become subject to AML obligations similar to those the commission already imposes on broker-dealers and other securities firms. But RIAs can look to recent SEC guidance and actions directed at the firms already covered by AML rules when considering their own compliance needs.

SEC officials have spoken publicly about the commission's current AML approach. Enforcement Director Andrew Ceresney has said the commission will pursue more stand-alone AML actions — "to send a clear message to the industry about the need for compliance."[4] The SEC will likely continue its recent trend of including AML charges in broader actions against firms that violate rules that encompass AML requirements. But Ceresney's speech signaled the SEC will look for AML violations independent of other deficiencies. Recent SEC settlements of AML violations have also required admissions of wrongdoing as part of the settlement terms — an enforcement practice Ceresney said the SEC will continue to use.

Ceresney noted the SEC's specific concern that broker-dealers file an insufficient number of SARs. Regulators expect a given firm's SAR filings to correspond to its size and the risk profile associated with its businesses. He said that the commission will be looking for violators based on deficient SAR filings and marshaled statistics to demonstrate the point:

> There are approximately 4,700 to 4,800 broker-dealers in the United States, all of whom are required to file SARs in appropriate circumstances. … [O]n average, each firm in the U. S. files about five SARs per year. … The nature of your industry and the sheer volume of transactions executed each year suggest to me that this number is far too low.

Preparing for AML Compliance: Think Broadly

Firms' AML deficiencies can arise from a variety of compliance areas. The best-prepared firms have performed initial AML risk assessments that take in a broad perspective. Recent SEC cases highlight the pitfalls of a narrow AML compliance focus and demonstrate the importance of developing a rigorous AML program that is thoroughly integrated with compliance throughout the organization.

A recent case against a broker-dealer demonstrates the need for integrated AML compliance. The SEC charged the firm with aiding and abetting illegal broker-dealer activity by a customer who held large deposits and engaged in sales of penny stocks. The firm's AML personnel detected suspicious activity and elevated their concerns, but they failed to recognize signs of multiple forms

4 See Ceresney's remarks at: http://www.sec.gov/news/speech/022515-spchc.html. See also a June 2015 speech by Kevin W. Goodman, the national associate director for broker-dealer examinations in the SEC's Office of Compliance Inspections and Examinations: http://www.sec.gov/news/speech/anti-money-laundering-an-often-overlooked-cornerstone.html.

AML-Related Actions Against Broker-Dealers

AML compliance has traditionally been a focus for the banking industry. But regulators now expect a widening array of financial firms to strengthen their controls against money laundering.

2011

SEPTEMBER 2011 | $995,205

The SEC ordered the firm to pay fines and disgorge profits for failing to supervise an employee who engaged in unregistered distributions of microcap securities through pump-and-dump schemes.

2012

SEPTEMBER 2012 | $5,931,785

FINRA, the SEC, and exchanges fined a firm for failing to monitor and supervise overseas customers who used the firm's systems to engage in manipulative and suspicious trading.

DECEMBER 2012 | $500,000

The SEC revoked the broker-dealer's registration, over the firm's failure to reasonably supervise and file SARs on day traders who were repeatedly engaged in market manipulation.

2013

AUGUST 2013 | $1,425,000

FINRA fined a broker-dealer for failing to establish an adequate AML compliance program that might have detected the firm's transaction of more than a billion shares of 20 unregistered penny stocks.

2014

JANUARY 2014 | $465,000

FINRA sanctioned the firm for not following its written AML procedures when it failed to supervise, and conduct a reasonable inquiry on, a customer trading unregistered securities in high volume.

JANUARY 2014 | $475,000

FINRA suspended the AML and chief compliance officers of an overseas bank's broker-dealer arm for failing to investigate a large transfer of funds by a customer with ties to organized crime, among other lapses.

FEBRUARY 2014 | $8,025,000

FINRA fined a broker-dealer and its AML compliance officer for failing to establish an adequate AML program to detect and file SARs on suspicious transactions by customers of banks in foreign bank-secrecy jurisdictions.

SEPTEMBER 2014 | $5,000,000

The SEC fined a large brokerage firm for failing to establish adequate controls to detect insider trading and for not preventing one of its brokers from trading on a customer's material nonpublic information.

NOVEMBER 2014 | $2,525,000

The SEC fined a broker-dealer and two executives for a lack of risk controls and violations of the market-access rule by providing customers — including some with thousands of anonymous overseas traders — with market access.

DECEMBER 2014 | $1,500,000

FINRA jointly fined two affiliated broker-dealers for lapses in their AML compliance program, after the dealers failed to adequately verify the identity of approximately 220,000 new account holders.

2015

JANUARY 2015 | $20,000,000

The SEC and FinCEN fined a securities broker-dealer for failing to establish and implement an adequate AML program, failing to conduct due diligence on a foreign correspondent account, and failing to comply with requirements under Section 311 of the Patriot Act.

AUGUST 2015 | $965,000

FINRA fined a broker-dealer and two compliance officers for improperly selling unregistered penny stocks and for not having implemented supervisory procedures to reasonably detect the suspicious transactions.

DECEMBER 2015 | $7,300,000

FINRA ordered a firm to pay a fine and disgorge profits over its lack of adequate supervisory and AML programs for detecting whether the microcap securities it liquidated for clients were registered with the SEC.

2016

FEBRUARY 2016 | $1,000,000

The SEC fined a brokerage firm for failing to maintain an adequate customer-identification program and allowing foreign entities to buy and sell securities without verifying the identities of the non-U.S. citizens who beneficially owned them.

MAY 2016 | $17,025,000

FINRA levied its highest AML fine against two affiliated broker-dealers, over systemic failures in their AML compliance, and separately punished the former AML compliance officer with a fine and suspension from the industry.

JUNE 2016 | $300,000

The SEC fined a brokerage firm for failing to file SARs on customers' suspicious trading.

of illegal activity, including unregistered broker-dealer activity and potential market manipulation. The SEC attributed the result — that no SARs were filed — to a failure of communication between the firm's compliance functions.

The SEC sanctioned another broker-dealer for failing to comply with the market-access rule.[5] The commission found that the firm's employees appropriately identified potential manipulation by a client to whom it provided market access, but that the firm's policies and procedures did not specify how employees should respond in such cases to concerns over both market access and money laundering. The SEC treated the conduct as a violation of the market-access rule, but further punished the firm for failing to file a SAR about the same activity.

A recent SEC insider-trading case involving employees of a major U.S. bank found a communication breakdown among multiple compliance groups with overlapping responsibilities. An employee and several clients made significant trades that the firm's policies required flagging, but the compliance group responsible for insider trading failed to escalate the matter. The SEC found that, in addition to the bank's insider-trading lapse, the bank violated its AML obligations by failing to relay information about the trades to the AML compliance group through a SAR or other regulatory notification.

These and similar cases show that effective AML programs are not walled off, and that close integration with other compliance functions[6] will strengthen a firm's AML program and give it optimal efficiency.[7] Advisers planning ahead will likely find that effective AML programs depend on enhancements they make in other areas of compliance.

What Can Firms Do Now?

RIAs might think about what resources to invest in their AML efforts by first considering the challenges any new AML requirements would pose to their businesses and compliance efforts. The design and execution of an AML risk assessment is a key initial challenge in establishing an effective AML program. The assessment will help gauge the effectiveness of existing controls and ensure that the firm's risk taking falls within an established risk appetite. Regulators will view the risk assessment as a foundational document that tells the firm's leadership where to allocate resources to strengthen any identified weaknesses. Advisers can also use the assessment to ask themselves whether they already incorporate some form of AML compliance into their operations or are affiliated with an entity subject to AML obligations.

FinCEN's proposed rule would allow RIAs affiliated with entities already subject to AML regulation to meet their obligations by extending the affiliate's existing programs to address risks posed by advisory activity. Dual registrants (entities registered as broker-dealers and investment advisers), advisers affiliated with bank holding companies, and advisers to registered investment companies like mutual funds may satisfy their obligations in this way. In contrast, advisers to private funds unaffiliated with financial institutions subject to AML regulation are likely to experience the greatest impact from the proposed rule.

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5 Rule 15c3-5 under the Securities Exchange Act of 1934.

6 Ceresney's speech noted the importance of "integrating AML compliance with other aspects of the compliance program and with the business generally" and ensuring "there is communication across different aspects of the compliance program and business, and … that siloes do not exist."

7 Ceresney also said, "It is critical to ensure that your AML compliance processes are leveraging the work done in other parts of your compliance programs, and vice versa."

There are also linkages between firms' AML programs and their other anti-financial-crime efforts, such as their compliance with U.S. and international sanctions and with anti-bribery laws like the Foreign Corrupt Practices Act. The risks and controls associated with sanctions and FCPA compliance have a high degree of overlap with an effective AML program: All, for instance, include requirements to know your customers, identify those with political affiliations (so-called politically exposed persons), and conduct regular risk assessments. Advisers can draw on any existing FCPA- and sanctions-related controls to build their AML programs. And firms starting afresh will enjoy a substantial advantage by building AML programs that also encompass FCPA and sanctions compliance. A firm's other characteristics will determine the amount of effort and resources required to establish an effective AML program. Relevant considerations include:

- Is the firm large or small in terms of customers, accounts, and assets under management?
- Does the firm engage in higher-risk businesses, such as trading microcap securities?
- Does the firm engage in transactions with clients or firms that are in high-risk jurisdictions?
- Is the firm's existing compliance structure fully integrated across offices and functions?

Conclusion

The precise contours of FinCEN's final rule remain unclear, but some set of SEC-enforced AML obligations for advisers seems likely. RIAs that begin building AML programs before the final rulemaking will enjoy a head start in what may only be a six-month compliance period. Advisers can conduct their initial risk assessments now and give themselves time to design risk-based AML programs that are optimal for their businesses but guard effectively against AML risk. Firms may also fold their AML risk assessments into the annual compliance reviews they are already required to conduct. Additional FinCEN rule proposals for advisers may be forthcoming and may add know-your-customer requirements, customer due diligence, and PATRIOT Act compliance to

Key Takeaways

- The proposal would require covered advisers to establish an AML program, file SARs, and comply with record-keeping and reporting obligations under the Bank Secrecy Act
- Regulators are demanding more for AML compliance — more resources, more sophisticated compliance programs, and more emphasis on a culture of compliance
- The SEC views AML compliance as an enforcement priority and is levying sizable monetary penalties and bringing AML actions as stand-alone violations
- The SEC is increasing its scrutiny of broker-dealers' SAR filings — expecting higher quantity and quality
- The expansive nature of AML compliance — violations can arise from almost any type of illegal or suspicious activity — demands that firms consider risk broadly throughout their businesses
- Designing and implementing an effective AML compliance program will require advisers to review and enhance other areas of compliance
- Advisers can begin building an effective AML program by conducting an enterprise AML risk assessment
- Advisers can determine whether any affiliates are financial institutions already subject to AML requirements, and assess whether they can expand existing AML programs to cover the advisory business

RIAs' initial AML obligations. Bringing investment advisers under the AML umbrella appears to be part of FinCEN's long-term vision and strategy, though uncertainty remains about timing and details.

To be effective, an AML program must be sustainable. Sustainability depends not only on the training of skilled full-time staff, but on reporting and information systems that can escalate issues to management and, ultimately, the board of directors. A well-designed program will promote a culture that values AML compliance not only as a legal imperative, but as a key pillar of the firm's reputation, which ultimately is its most valuable asset. For firms that have not incorporated some form of AML compliance into their operations, now is the time to begin planning for the challenges they may face.

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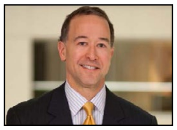

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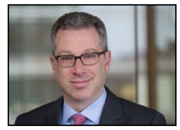

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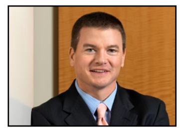

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