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ALERT MEMORANDUM

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FinCEN Proposes AML Regulations for Investment Advisers

On August 25, 2015, the U.S. Treasury Department's Financial Crimes Enforcement Network ("FinCEN") released a long-awaited notice of proposed rulemaking (the "Proposed Rule")[1] that would impose anti-money laundering ("AML") compliance obligations on investment advisers pursuant to the Bank Secrecy Act (the "BSA"),[2] taking steps to close what regulators perceive as a gap in the money laundering defenses of the U.S. financial system. The Proposed Rule has already drawn controversy, with some commenters questioning whether it goes far enough and others questioning the potential compliance costs for investment advisers.

Key features of the Proposed Rule include the following:

- The Proposed Rule would apply to any U.S. or non-U.S. investment adviser that has registered, or is required to register, with the Securities and Exchange Commission (the "SEC") under the Investment Advisers Act of 1940, as amended (the "Advisers Act", and such advisers, "Covered Advisers").[3] Exempt reporting advisers, state-registered advisers and advisers to commodity pools would not be covered by the Proposed Rule.

- Covered Advisers would be required to establish an AML program consistent with the requirements of the BSA, including risk-based policies, procedures and controls; independent testing; designation of an AML compliance officer or committee; and appropriate employee training.

- Covered Advisers would be subject to provisions of the BSA that require the filing of suspicious activity reports ("SARs") and currency transaction reports ("CTRs") and that impose certain other recordkeeping requirements, even where the Covered Adviser acts as subadviser to another Covered Adviser already subject to these provisions.

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1 See FinCEN Release, FinCEN Proposes AML Regulations for Investment Advisers (Aug. 25, 2015), http://www.fincen.gov/news_room/nr/pdf/20150825.pdf. The Proposed Rule was published in the Federal Register on September 1, 2015. Anti-Money Laundering Program and Suspicious Activity Report Filing Requirements for Registered Investment Advisers, 80 Fed. Reg. 52,680 (Sept. 1, 2015) (proposed rule).

2 The BSA refers to the Currency and Financial Transactions Reporting Act of 1970, as amended by the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001, Pub. L. No. 107-56, 115 Stat. 272 (2001) (the "USA PATRIOT Act"), and other legislation. The BSA is codified at 12 U.S.C. §§ 1829b, 1951–1959, 31 U.S.C. §§ 5311–5314 and 5316–5332 and notes thereto, with implementing regulations at 31 C.F.R. ch. X. See also 31 C.F.R. § 1010.100(e).

3 The SEC regulates investment advisers under the Advisers Act and the rules adopted under the Advisers Act. See 15 U.S.C. §§ 80b-1 to 80b-21 and 17 C.F.R. pt. 275.

- FinCEN intends to delegate examination responsibility to the SEC. If the Proposed Rule is adopted, Covered Advisers could face civil or criminal liability for deficient AML programs or other compliance failures.

- Covered Advisers that are dual-registered as investment advisers and broker-dealers with the SEC, or that are subject to an enterprise-wide compliance program covering the adviser and its other regulated affiliates, would be permitted to rely on a single comprehensive or enterprise-wide AML program so long as the program covers all activities and businesses subject to regulation under the BSA.

- The Proposed Rule would add Covered Advisers to the general definition of "financial institutions" subject to the BSA; however, a number of the AML requirements applicable to other financial institutions under the BSA would not apply to Covered Advisers.

    - Most notably, the Proposed Rule would not require Covered Advisers to establish a formal customer identification program ("CIP") or comply with the pending proposed rulemaking that would require covered financial institutions to identify and verify beneficial owners of legal entity customers[4] (though it indicates that FinCEN anticipates addressing CIP requirements for Covered Advisers in a future joint rulemaking effort with the SEC and, as a practical matter, CIP procedures are likely to be a part of any AML program).

    - Other requirements under the BSA and the USA PATRIOT Act that would not apply to Covered Advisers under the Proposed Rule include requirements to conduct enhanced due diligence on private banking and foreign bank correspondent accounts, compliance with FinCEN-imposed special measures to combat money laundering, prohibitions on maintaining correspondent accounts for shell banks, and certain recordkeeping requirements with respect to correspondent accounts maintained for foreign banks, although again FinCEN notes that it is considering whether some or all of these requirements should be applied to Covered Advisers in the future.

- If adopted as proposed, the Proposed Rule's AML program and SAR requirements would apply to Covered Advisers six months after publication of the final rule. The Proposed Rule does not specify when the other reporting and recordkeeping requirements would take effect.

[4] Customer Due Diligence Requirements for Financial Institutions, 79 Fed. Reg. 45,151 (Aug. 4, 2014) (proposed rule) (the "Beneficial Ownership Proposal").

FinCEN has asked for comments on all aspect of the Proposed Rule and has embedded a number of specific questions in the Proposed Rule's preamble.[5] Comments are due by November 2, 2015.

I. Background

FinCEN has long contemplated imposing AML compliance responsibilities on investment advisers pursuant to the BSA. FinCEN views investment advisers as capable of playing an important role in safeguarding the financial system against money laundering, given the volume of assets that they manage—a reported $61.9 trillion as of June 2, 2014—and their unique understanding of the movement of funds through the financial system by virtue of the broad range of advisory services that they furnish to a diverse set of clients. Furthermore, FinCEN believes that the lack of AML program requirements for investment advisers has made them a target for money launderers and terrorist financiers seeking low-risk access to the U.S. financial system. FinCEN believes that the unique information an investment adviser has about its clients' beneficial ownership and their financial activities gives it an important role in monitoring and safeguarding the financial system from fraud, money laundering, terrorist financing and other financial crimes.

By contrast, some in the industry have argued that imposing separate AML program requirements on investment advisers is unnecessary, given that the transactions relating to their business must be processed through a financial institution already subject to AML program requirements (i.e., a bank or broker-dealer), and that the provision of investment advisory services does not present a high risk of money laundering.

In 2003, FinCEN published a notice of proposed rulemaking to require certain investment advisers to establish AML programs (the "2003 Proposal").[6] The 2003 Proposal was meant to complement a notice of proposed rulemaking issued by FinCEN in 2002 that would have required unregistered investment companies, including hedge funds, private equity funds and real estate funds, to establish AML programs (the "2002 UIC Proposal").[7] FinCEN withdrew the 2002 UIC Proposal and the 2003 Proposal in 2008 in order to reconsider its approach to investment advisers, citing the passage of time since the initial proposals were published and noting that investment advisory activity would not be wholly outside the BSA regulatory regime, since investment advisers must conduct transactions through, and place client assets with other

5 FinCEN's specific questions are set out in the Appendix to this memorandum.

6 See Anti-Money Laundering Programs for Investment Advisers, 68 Fed. Reg. 23,646 (May 5, 2003) (proposed rule).

7 See Anti-Money Laundering Programs for Unregistered Investment Companies, 67 Fed. Reg. 60,617 (Sept. 26, 2002) (proposed rule). Another 2003 proposal, which would have extended AML program requirements to commodity trading advisers, was also withdrawn in 2008. See Anti-Money Laundering Programs for Commodity Trading Advisers, 68 Fed. Reg. 23,640 (May 5, 2003) (proposed rule); Withdrawal of the Notice of Proposed Rulemaking; Anti-Money Laundering Programs for Commodity Trading Advisers, 73 Fed. Reg. 65,567 (Nov. 4, 2008).

regulated financial institutions.[8] Since the withdrawal, FinCEN has periodically indicated that a replacement proposal for investment advisers likely would be forthcoming.[9] The Proposed Rule is intended to provide substantially the same coverage of the asset management industry as the 2003 Proposal and the 2002 UIC Proposal would have in combination.[10]

The Proposed Rule follows an approach similar to that of the 2003 Proposal by requiring investment advisers to implement an AML program consistent with the requirements of the BSA.[11] The principal differences are (1) the scope of investment advisers that would be subject to the Proposed Rule (reflecting the expansion of registration requirements under the Advisers Act between 2003 and today) and (2) the imposition of a SAR filing requirement on Covered Advisers and the inclusion of "investment advisers" in the general regulatory definition of "financial institution" that triggers BSA requirements broadly applicable to financial institutions regardless of industry.

II. Scope of Covered Advisers Subject to the Proposed Rule

A. Covered Advisers would include any person who is registered or required to register with the SEC under section 203 of the Advisers Act, but not so-called "exempt reporting advisers."

B. Key Considerations

1. Under the Advisers Act, an investment adviser's assets under management ("AUM") generally determine whether federal registration is required or prohibited.[12] As a result, mid-sized (AUM between $25 million and

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8 See Withdrawal of the Notice of Proposed Rulemaking; Anti-Money Laundering Programs for Unregistered Investment Companies, 73 Fed. Reg. 65,569 (Nov. 4, 2008); and Withdrawal of the Notice of Proposed Rulemaking; Anti-Money Laundering Programs for Investment Advisers, 73 Fed. Reg. 65,568 (Nov. 4, 2008).

9 See Jennifer Shasky Calvery, Director, FinCEN, Remarks to the Securities Industry and Financial Markets Association ("SIFMA") Anti-Money Laundering and Financial Crimes Conference (Feb. 27, 2013), http://www.fincen.gov/news_room/speech/html/20130227.html. See also James H. Freis, Jr., Director, FinCEN, Remarks to the ABA/ABA Money Laundering Enforcement Conference (Nov. 15, 2011), http://www.fincen.gov/news_room/speech/html/20111115.html.

10 In the preamble to the Proposed Rule, FinCEN indicates that it reconsidered the "two-pronged" approach proposed in 2002 and 2003 in light of significant changes to the regulatory framework for investment advisers, in particular due to amendments to the Advisers Act included in the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 that expanded the scope of investment advisers required to register with the SEC to include most investment advisers to hedge funds, private equity funds and other private funds, many of which were not previously required to register. See Rules Implementing Amendments to the Investment Advisers Act of 1940, 76 Fed. Reg. 42,950 (July 19, 2011). The 2002 UIC Proposal would also have covered certain commodity pools. The Proposed Rule indicates that FinCEN has deferred consideration of commodity pools until a later date.

11 See 31 U.S.C. § 5318(h).

12 Advisers that are subject to registration under the Advisers Act and whose principal office and place of business are outside the United States are permitted to register with the SEC without regard to their AUM. See Rules Implementing Amendments to the Investment Advisers Act of 1940, 62 Fed. Reg. 28,112, 28,119 (May 22, 1997).

$100 million) and small (AUM less than $25 million) investment advisers, which generally are regulated by the states and not registered with the SEC, generally would not be subject to the Proposed Rule.

2. Exempt reporting advisers—private fund and venture capital fund advisers exempt from registration but required to file certain reports with the SEC—would also not be subject to the Proposed Rule.[13] FinCEN has specifically requested comments regarding whether exempt reporting advisers and other large exempt advisers should be included in its definition of Covered Adviser.

3. Unlike the 2003 Proposal, which was limited to advisers whose principal office and place of business is located in the United States, the Proposed Rule would apply equally to U.S. and non-U.S. investment advisers required to register under the Advisers Act. However, the compliance obligations imposed by the Proposed Rule would be geographically limited, applicable only to a Covered Adviser's agents, agencies, branches and offices located within the United States.

   (a) It is a well-established principle under FinCEN's regulations that only the U.S. operations of financial institutions are subject to AML programs, SAR reporting and other reporting, recordkeeping and compliance obligations under the BSA.[14]

   (b) The Covered Adviser's U.S. operations, however, would need to address any AML risks presented to the U.S. operations through their relationships with their foreign offices and operations.

4. The application of the Proposed Rule to all SEC-registered advisers could affect advisers in a broad range of contexts, including private fund advisers, subadvisers, dual-registered investment advisers, non-U.S. investment advisers and investment advisers to registered investment companies, not all of which would appear to present a high risk of engaging in money laundering activities.

5. FinCEN has limited application of the Proposed Rule to SEC-registered advisers in order to align FinCEN's regulatory framework with federal functional regulation. FinCEN intends to delegate to the SEC its authority

[13] See Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign Private Advisers, 76 Fed. Reg. 39,646 (July 6, 2011).

[14] See 31 C.F.R. § 1010.100(t) (limiting the definition of financial institution to an institution's U.S. agents, agencies, branches and offices).

to examine Covered Advisers and to work with the SEC to develop consistent procedures for application of the BSA to Covered Advisers.

6. FinCEN recognizes, however, that other investment advisers may also be at risk of abuse by money launderers and notes that it may consider future rulemaking to impose AML requirements on advisers that are state-regulated and/or exempt from SEC registration. Because the SEC does not regularly examine state-regulated advisers and exempt reporting advisers, such future rulemaking would either require FinCEN to examine advisers for BSA compliance, or state securities authorities and the SEC to expand their examination practices with respect to such advisers.

7. The Proposed Rule would not apply to commodity pools (which were included in the 2002 UIC Proposal) or commodity trading advisers.

III. Overview of AML Obligations Imposed on Covered Advisers by the Proposed Rule

A. There are three broad categories of AML compliance obligations that would be imposed on Covered Advisers under the Proposed Rule:

1. The requirement to develop and implement a written AML program;

2. The requirement to file SARs; and

3. Other reporting, recordkeeping and compliance obligations resulting from including Covered Advisers in the definition of "financial institutions" under FinCEN's BSA regulations.

B. Each of these categories is described in further detail in the sections below.

IV. AML Program Requirements

A. Covered Advisers would be required to develop and implement a written AML program under the Proposed Rule that includes, at a minimum, the following features generally required under the BSA for other financial institutions:[15]

1. Policies, procedures, and internal controls reasonably designed to prevent the investment adviser from being used for money laundering or the financing of terrorist activities and to achieve and monitor compliance with applicable provisions of the BSA;

[15] See 31 U.S.C. § 5318(h).

2. Provision for periodic independent testing of the program by independent internal personnel (e.g., an audit function) or a qualified unaffiliated service provider;

3. Designation of an AML compliance officer or committee (which could be the Covered Adviser's Chief Compliance Officer ("CCO") or another person or committee); and

4. An ongoing employee training program.

B. The AML program would need to be approved in writing by the Covered Adviser's board of directors or trustees, as applicable, or if no such entity or body exists, by its sole proprietor, general partner or other persons that have functions similar to those of a board of directors.

C. The deadline for establishing and implementing an AML program would be six months following publication of the final rule.

D. Key Considerations

1. The Proposed Rule reaffirms the principle underlying the USA PATRIOT Act amendments to the BSA that an effective AML program can and should be risk-focused, and it is intended to give Covered Advisers the flexibility to design an AML program tailored to the specific risks of the advisory services they provide and the clients they advise.

2. An effective, risk-based AML program is expected to be based on an AML risk assessment of the Covered Adviser's business activities, which should review the types of advisory services the Covered Adviser provides and the nature of the Covered Adviser's clients. Policies, procedures and controls should be based on the result of this risk assessment.

(a) Among the factors a Covered Adviser would be expected to consider in developing its risk assessment would be the source of a client's funds and the jurisdiction in which the client is located. If a client is a legal entity, the type and jurisdiction of the legal entity and any relevant applicable statutory and regulatory regimes would be relevant. Historical experience with a client and references provided by other financial institutions may also be relevant factors.

(b) Although the Proposed Rule does not explicitly address beneficial ownership or customer identification programs (see Section IV.D.4 below), the Covered Adviser's ability to identify a client's ultimate

owners may play an important role in its risk assessment. Covered Advisers may also wish to anticipate likely future rulemaking in this area in designing their AML programs

3. FinCEN expects a Covered Adviser's AML program to address all of its advisory activities, including, among other things, advisory services that do not include the management of client assets; subadvisory services; and advisory services provided under wrap fee programs. However, the preamble to the Proposed Rule recognizes that not all advisory activities and clients present the same level of AML risk and discusses FinCEN's expectations for how a Covered Adviser should risk-rate a number of specific types of clients and activities.

   (a) Advisory services that do not include the management of client assets: A Covered Adviser's AML program would be required to address all of its advisory services, including those services that do not involve the management of client assets, such as pension consulting, securities newsletters, research reports and financial planning. Although the Proposed Rule does not specify how a Covered Adviser's AML program should apply to such activities, presumably such activities would generally be viewed as low risk under a risk-based AML program and not require the types of procedures and controls that might be applied to higher-risk advisory activity.

   (b) Subadvisory services: Covered Advisers would be expected to apply their AML programs, including SAR requirements, to their subadvisory activity and cannot rely on the fact that the primary adviser may also have an AML program. FinCEN has noted the potential for the duplication of AML efforts under the Proposed Rule and has requested comments addressing the overlap between the primary adviser's and subadviser's AML programs (although FinCEN notes that there may be circumstances where only the subadviser, and not the primary adviser, would be a Covered Adviser subject to the Proposed Rule).

      (i) In the context of applying CIP requirements, FinCEN has sometimes been willing to accept a practical division of responsibility between financial intermediaries for identification of the ultimate underlying customers in, e.g., a formal reliance arrangement (which shifts responsibility for the affected function) pursuant to the CIP regulations[16]

[16] See, e.g., 31 C.F.R. §§ 1020.220(a)(6), 1023.220(a)(6). See also note 20 below.

or in contexts where only one of the financial institutions is required to treat the underlying client as a customer.[17] Neither of these situations eliminates the need for the other financial institution to have risk-based AML policies, procedures and controls that apply to the relationship or activity.

(ii) Even where formal reliance on another regulated entity's AML program is not permitted, contractual delegation of AML functions is generally allowed, although the delegating financial institution would retain ultimate responsibility for its AML program (see Section IV.D.7 below).

(c) Individual and institutional non-fund clients: FinCEN considers Covered Advisers to be vulnerable to AML risks when serving clients that are not pooled investment vehicles. Risk assessments of services provided to such clients should account for the types of accounts offered (e.g., managed accounts), the types of clients opening such accounts and how the accounts are funded.

(d) Registered open-end fund clients: Mutual funds and other open-end funds registered under the Investment Company Act of 1940 (the "ICA") may present lower AML risks because they are already required to, among other things, establish and maintain CIP and AML programs and file SARs.[18]

(e) Registered closed-end fund clients: Similarly, closed-end funds registered under the ICA may present relatively lower AML risks because shares of closed-end funds are traded through broker-dealers or banks, which are already subject to the BSA's AML program requirements.[19]

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17 See, e.g., Bank Secrecy Act Obligations of a U.S. Clearing Broker-Dealer Establishing a Fully Disclosed Clearing Relationship with a Foreign Financial Institution, FIN–2008–R008 (June 3, 2008); Customer Identification Program Rule No-Action Position Respecting Broker-Dealers Operating Under Fully Disclosed Clearing Agreements According to Certain Functional Allocations, FIN–2008–G002 (Mar. 4, 2008); Application of the Customer Identification Program Rule to Futures Commission Merchants Operating as Executing and Clearing Brokers in Give-Up Arrangements, FIN–2007–G001 (Apr. 20, 2007); Guidance from the Staffs of the Department of the Treasury and the SEC, Question and Answer Regarding the Broker-Dealer Customer Identification Program Rule (Oct. 1, 2003).

18 See 31 C.F.R. pt. 1024 (AML requirements for mutual funds).

19 See 31 C.F.R. pt. 1020 (AML requirements for banks); 31 C.F.R. pt. 1023 (AML requirements for brokers or dealers in securities).

(f) Private funds and other unregistered pooled investment vehicle clients: Conversely, private funds and other unregistered pooled investment vehicles may present a range of AML risks, and FinCEN expects Covered Advisers to risk-rate such clients. In performing these risk ratings, Covered Advisers would be expected to assess the AML risks presented by a private fund's underlying investors, and, in particular, to consider the increased risks when there is a lack of transparency regarding the fund's underlying investors (e.g., when the investors in a fund are themselves pooled investment vehicles). We would also expect the Covered Adviser to take into account the existence and robustness of any AML program maintained by the private fund.

(g) Wrap fee programs: FinCEN expects Covered Advisers that participate in wrap fee programs with affiliated or unaffiliated broker-dealers to apply their AML program to the underlying clients of the wrap fee program, notwithstanding that the sponsoring broker-dealer would also be subject to AML requirements with respect to such clients.

4. The Proposed Rule contains no specific CIP or customer or beneficial ownership diligence requirement, but Covered Advisers may still be expected to apply diligence to their customers and their customers' underlying investors.

(a) The risk-based approach to AML compliance and requirements to monitor for suspicious activity implies that Covered Advisers would in at least some cases be expected to conduct diligence on the identities of their clients and their ultimate beneficial owners (who may be insulated by several layers of legal entity intermediaries).

(b) Establishing risk-based procedures to conduct beneficial owner diligence will be especially important to consider for advisers to offshore funds, where diligence requirements for U.S. securities law purposes are generally limited to ascertaining whether the fund qualifies as a non-U.S. person.

(c) The lack of a specific CIP requirement, however, suggests that FinCEN intends to permit Covered Advisers flexibility in how they implement that diligence in light of the specific risks presented by the types of services provided by the adviser, the types of client served by the adviser, and their underlying investors, if any.

(d) Nevertheless, the absence of specific CIP requirements may raise questions with other financial institutions subject to CIP, including when it would be reasonable to delegate CIP or customer diligence to Covered Advisers. [20]

(e) If the Beneficial Ownership Proposal is adopted, financial institutions subject to that rule are likely to expect investment advisers to implement similar beneficial ownership diligence procedures, even though as currently proposed the Beneficial Ownership Proposal would not apply to Covered Advisers pending future joint FinCEN/SEC rulemaking.[21]

5. The Proposed Rule suggests that Covered Advisers should be able to build upon their existing Advisers' Act compliance policies, procedures and internal controls to implement an AML program and appropriate recordkeeping, reporting and monitoring systems. Among other things, it should generally be possible for a Covered Adviser to appoint its existing CCO to serve as the AML compliance officer under the Proposed Rule.

(a) The mandate to designate an AML compliance officer does not require the individual that serves as the AML compliance officer be dedicated full time to BSA compliance, provided a part-time role is appropriate to the Covered Adviser's size and scope of advisory services and clients.

(b) The preamble to the Proposed Rule specifies that the AML compliance officer must be an "officer of the investment adviser" but otherwise does not address whether the AML compliance officer can, like the CCO, be dual-hatted with an affiliated entity or

[20] Financial institutions subject to CIP requirements are permitted to rely on other financial institutions to conduct CIP when: (1) such reliance is reasonable under the circumstances; (2) the other financial institution is subject to a rule implementing the AML compliance program requirements of 31 U.S.C. § 5318(h), and is regulated by a federal functional regulator; and (3) the other financial institution has entered into a contract requiring it to certify annually that it has implemented its own AML program, and that it will perform specified requirements of the CIP of the financial institution seeking to rely on the other financial institution. See, e.g., 31 C.F.R. § 1023.220(a)(6). See also SIFMA, SEC No-Action Letter (Jan. 9, 2015) (the "CIP No-Action Letter") (permitting broker-dealers to rely on SEC-registered investment advisers to perform CIP under certain circumstances, until such time as investment advisers become subject to an AML program requirement under 31 U.S.C. § 5318(h)).

[21] The Beneficial Ownership Proposal would require, among other things, that covered financial institutions verify the identities of certain beneficial owners of their legal entity customers, generally defined as (1) any natural persons who have direct or indirect ownership of 25% (or more) of the legal entity customer; and (2) at least one individual with significant responsibility to control, manage or direct a legal entity customer. It would also formalize, as part of the AML program requirement for covered financial institutions, preexisting expectations that these financial institutions should have procedures to understand the nature and purpose of customer relationships and conduct ongoing monitoring to maintain and update customer information and to identify and report suspicious transactions.

otherwise outsourced. We expect that comments will request clarification on whether similar arrangements will be permitted to meet the requirements for an AML compliance officer.

6. Many investment advisers already maintain AML programs on a voluntary basis as a matter of prudent risk management, to satisfy the expectations of counterparties and service providers, and/or to facilitate a broker-dealer's reliance on the investment adviser to conduct aspects of the broker-dealer's CIP pursuant to the CIP No-Action Letter. Others may be subject to AML programs established to satisfy AML requirements already applicable to them or their affiliates (e.g., if the adviser is dual-registered as a broker-dealer with the SEC or affiliated with a bank holding company that has an enterprise-wide AML program).

   (a) Covered Advisers that are dual-registered, or that are subject to an enterprise-wide AML compliance program covering the Covered Adviser and its other regulated affiliates, would be permitted to rely on a single comprehensive or enterprise-wide AML program so long as the program covers all activities and businesses subject to regulation under the BSA.

   (b) The burden of the Proposed Rule on Covered Advisers will depend in part on how closely existing programs fit the requirements of the Proposed Rule and evolving regulatory expectations established through SEC examination and future guidance.

   (c) If a Covered Adviser relies on an enterprise-wide program, it would only be required to adopt those provisions of the enterprise-wide program that are required by the Proposed Rule; provisions that are only required for other parts of the adviser's organization would not need to be applied to the adviser's activities.

7. Covered Advisers would be permitted to contractually delegate certain functions under their AML programs to agents or third-party service providers; however, the Covered Adviser would retain full responsibility for the effectiveness of its AML program and for ensuring that FinCEN and the SEC are able to obtain records relating to the AML program. This could permit Covered Advisers to delegate much of their day-to-day AML program responsibilities to subadvisers, administrators, custodians or other service providers.

V. SAR Filing Requirements

A. The Proposed Rule would add Covered Advisers to the list of financial institutions required to monitor for and report suspicious activity under the BSA, which currently includes banks, casinos, money services businesses, broker-dealers in securities, mutual funds, insurance companies, futures commission merchants and introducing brokers in commodities.

B. Covered Advisers would be required to file a SAR for any transaction meeting the following criteria (which track those that apply to other financial institutions):

1. The transaction is "conducted or attempted by, at, or through" a Covered Adviser;

2. The transaction involves or aggregates funds or other assets of at least $5,000; and

3. The Covered Adviser knows, suspects or has reason to suspect that the transaction:

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

b. Is designed, whether through structuring or other means, to evade BSA requirements;

c. Has no business or apparent lawful purpose and no reasonable explanation for the transaction is available after examining the available facts; or

d. Facilitates criminal activity.

C. Generally, a SAR would need to be filed within 30 days after a Covered Adviser becomes aware of a suspicious transaction, and supporting documentation relating to each SAR would need to be collected, maintained and made available upon request to FinCEN and other law enforcement agencies.[22]

D. Where a situation involves actual or suspected violations of law that require immediate attention, such as suspected terrorist financing or ongoing money laundering schemes, Covered Advisers would also be required to provide

[22] Pursuant to the Proposed Rule, copies of filed SARs and supporting documentation would need to be maintained for a period of five years from the date of filing.

immediate notification by telephone to an appropriate law enforcement authority (in addition to filing a SAR).

E. Covered Advisers would be permitted and encouraged to file a SAR voluntarily with respect to any transaction not meeting the above criteria if the Covered Adviser believes the transaction to be relevant to a possible violation of any law or regulation.

F. If more than one regulated financial institution subject to a SAR filing mandate were obligated to file a SAR with respect to a transaction, they would be able to file a single "joint SAR" containing all relevant facts and identifying each financial institution. Both institutions would be required to maintain copies of the report and supporting documentation.

G. Both required and voluntarily filed SARs would benefit from the protection from liability provided in 31 U.S.C. § 5318(g)(3), which provides a safe harbor from civil liability for financial institutions that file SARs. The safe harbor protects SAR filers, and their employees, officers, directors and agents, from civil liability that might otherwise arise from the filing of a SAR or from any failure to provide notice of such disclosure to the person who is the subject of or identified in the SAR under any U.S. or state law or regulation or contract or other legally enforceable agreement. This broad limitation on civil liability is designed to promote compliance with SAR filing requirements.

H. Disclosure of SARs, or of information that would reveal the existence of a SAR, by a Covered Adviser or any employee, officer, director or agent thereof, is strictly prohibited, subject to a limited number of exemptions for disclosing information to (1) FinCEN or other law enforcement agencies or to the federal regulatory agency responsible for examination of the adviser, and (2) other financial institutions, but only for the purposes of preparing a joint SAR (see above). Sharing SARs (or information indicating the existence of a SAR) within an investment adviser's corporate organizational structure (e.g., between affiliates) would not be permitted under the Proposed Rule unless and until FinCEN were to release further guidance or rulemaking on the circumstances under which such information sharing can occur. FinCEN has indicated that it is considering such guidance. In any event, sharing of information underlying a SAR within an organization is permitted

I. Covered Advisers would be permitted to delegate SAR requirements to an agent or third-party service provider; however, the adviser would remain ultimately responsible for its compliance with the requirements of the Proposed Rule, including the requirement for it and its agents to maintain SAR confidentiality.

J. The mandatory SAR filing requirement would apply to transactions initiated after the full implementation of an AML program—i.e., six months after publication of a final rule—but Covered Advisers are encouraged to begin voluntary filings as soon as the rule is finalized.

K. Key Considerations

1. The requirement to file SARs necessarily involves a requirement to include monitoring of client activities and relationships for suspicious activity in a Covered Adviser's AML program. The determination to file a SAR should be based on all the facts and circumstances relating to the transaction and the client involved.

2. The preamble to the Proposed Rule identifies examples of suspicious transactions and red flags that a Covered Adviser should be able to identify through its suspicious transaction monitoring program. In particular, the Proposed Rule suggests Covered Advisers should monitor for structuring transactions designed to avoid CTR and other currency reporting requirements and for evidence of fraudulent activity. Specific red flags suggested in the Proposed Rule include:

(a) A client exhibits unusual concern regarding the adviser's compliance with government reporting requirements or is reluctant or refuses to reveal any information concerning business activities, or furnishes unusual or suspicious identification or business documents;

(b) A client appears to be acting as the agent for another entity but declines, evades, or is reluctant to provide any information in response to questions about that entity;

(c) A client requests that a transaction be processed in such a manner as to avoid the adviser's normal documentation requirements;

(d) A client exhibits a total lack of concern regarding performance returns or risk;

(e) A pattern of inexplicable and unusual withdrawals, contrary to the client's stated investment objectives;

(f) Structuring by funding a managed account or subscribing to a private fund by using multiple wire transfers from different accounts maintained at different financial institutions; and

(g) Other unusual wire activity that does not correlate with a client's stated investment objectives.

3. FinCEN has issued specific guidance permitting certain other covered financial institutions to share SARs, subject to certain limitations, with their parent organizations, head offices (for non-U.S. branches and agencies), controlling investment advisers (for mutual funds) and affiliates.[23] The Proposed Rule explicitly does not extend this relief to Covered Advisers, but the preamble discussion suggests that FinCEN would likely consider expanding that guidance to Covered Advisers in connection with finalizing the Proposed Rule. However, even where Covered Advisers may not share SARs or the fact that a SAR has been filed, they remain free to report the underlying facts to their affiliates.

VI. Other BSA Compliance Obligations

A. Under the Proposed Rule, Covered Advisers would be included within the definition of "financial institutions" in the regulations implementing the BSA.[24]

B. As a result, Covered Advisers would become subject to a number of regulatory requirements generally applicable to "financial institutions" under the BSA including:

1. The requirement to file a CTR for a transaction involving a transfer of more than $10,000 in currency (which would replace the Covered Adviser's current Form 8300 filing requirement for cash receipts in excess of $10,000);[25]

2. The requirements to obtain and retain certain information with respect to "transmittals of funds"[26] that equal or exceed $3,000 and to ensure that

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[23] See Sharing Suspicious Activity Reports by Securities Broker-Dealers, Mutual Funds, Futures Commission Merchants, and Introducing Brokers in Commodities with Certain U.S. Affiliates, FIN–2010–G005 (Nov. 23, 2010) and Sharing Suspicious Activity Reports by Depository Institutions with Certain U.S. Affiliates, FIN–2010–G006 (Nov. 23, 2010); Frequently Asked Questions: Suspicious Activity Reporting Requirements for Mutual Funds, FIN–2006–G013 (Oct. 4, 2006); FinCEN Guidance on Sharing of Suspicious Activity Reports by Securities Broker-Dealers, Futures Commission Merchants, and Introducing Brokers in Commodities (Jan. 20, 2006); Interagency Guidance on Sharing Suspicious Activity Reports with Head Offices and Controlling Companies (Jan. 20, 2006).

[24] See 31 C.F.R. § 1010.100(t).

[25] See 31 C.F.R. § 1010.311.

[26] A "transmittal of funds" is defined in 31 C.F.R. § 1010.100(ddd) and, in general terms, includes funds transfers processed by banks and financial institutions.

certain information "travels" to other financial institutions along with such transmittals (the so-called "Recordkeeping Rule" and "Travel Rule");[27]

3. The requirement, with respect to amounts exceeding $10,000, to create and retain records for extensions of credit and cross-border transfers of currency, monetary instruments, checks, investment securities and credit;[28] and

4. The special information sharing procedures established under Sections 314(a) and (b) of the USA PATRIOT Act that require financial institutions to search their records to determine whether they have maintained an account or conducted a transaction with a person that law enforcement has certified is suspected of engaging in terrorist activity or money laundering and that provide protection from civil liability for financial institutions that share otherwise confidential information with each other for purposes of facilitating BSA compliance.[29]

C. Key Considerations

1. Application of these BSA recordkeeping and reporting requirements to Covered Advisers could prove to be unnecessarily burdensome and duplicative and is likely to be challenged in industry comments.

   (a) For Covered Advisers that do not actively manage client funds and assets or do not have access to client funds and assets (i.e., "custody" for purposes of the Advisers Act), compliance with these requirements could be particularly burdensome. In this context, banks and broker-dealers are the principal financial institutions involved in holding and moving funds and assets, and the Covered Adviser would not be in a position to have or obtain certain of this information. Despite this lack of access to information, the Proposed Rule would not provide an exemption from these requirements for advisers that do not have custody of client funds and assets.

   (b) Even advisers with "custody" for purposes of the Advisers Act must maintain all client funds and assets with a qualified custodian (e.g., a bank or broker-dealer) that is already subject to these requirements, leading to duplication of efforts in a context where

[27] See 31 C.F.R. § 1010.410(e) and (f).

[28] See 31 C.F.R. § 1010.410(a)–(c).

[29] See 31 C.F.R. §§ 1010.500–.540.

the financial institutions that actually hold and move funds and securities are better positioned to file the appropriate reports and retain appropriate records.

2. The Proposed Rule does not indicate why FinCEN decided to propose to apply these requirements to Covered Advisers, when it had not done so in the 2003 Proposal.

3. Because Covered Advisers will now be incorporated into the general definition of "financial institution" in FinCEN's regulations, they may become subject to new AML compliance obligations if, and to the extent that, FinCEN promulgates regulations that apply to all "financial institutions" under the BSA, as opposed to only specific categories of financial institutions.

VII. Potential Future Rulemakings

The preamble to the Proposed Rule indicates that FinCEN has not foreclosed proposing additional rules addressing the status and obligations of investment advisers under the BSA. FinCEN has indicated it may consider applying AML compliance obligations to exempt reporting advisers, state-registered advisers and other advisers outside the scope of the Proposed Rule. FinCEN's commentary also notes that it will address in future rulemakings whether Covered Advisers should be subject to:

A. A CIP requirement established under an anticipated joint rulemaking effort with the SEC;

B. The Beneficial Ownership Proposal that FinCEN has recently proposed incorporating into AML program requirements for other financial institutions;

C. Regulations implementing Section 311 of the USA PATRIOT Act, which require financial institutions to take certain "special measures" against foreign jurisdictions, institutions, classes of transactions, or types of accounts that FinCEN designates as a "primary money laundering concern";

D. Regulations implementing Section 313 of the USA PATRIOT Act, which prohibit financial institutions from providing correspondent accounts to foreign shell banks and require such financial institutions to take reasonable steps to ensure that correspondent accounts provided to foreign banks are not used to indirectly provide banking services to foreign shell banks;

E. Regulations implementing Section 312 of the USA PATRIOT Act, which require a financial institution to perform due diligence and, in some cases, enhanced due diligence, with regard to correspondent accounts established or maintained for

foreign financial institutions and private banking accounts established or maintained for non-U.S. persons; and

F. Regulations implementing Section 319(b) of the USA PATRIOT Act, which require the financial institutions that provide correspondent accounts to foreign banks to maintain records of the ownership of such foreign banks and their agents for service of process in the United States, and require the termination of correspondent accounts of foreign banks that fail to comply with or fail to contest lawful subpoenas or other law enforcement requests.

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Appendix

Specific Questions for Comment Included in the Proposed Rule

Proposed Definition of Investment Adviser

1. Does the exclusion from the definition of investment adviser of those large advisers that qualify for and use an exemption from the requirement to register with the SEC place this class of investment adviser at risk for abuse by money launderers, terrorist financers, or other illicit actors? If so, should FinCEN include these advisers in its definition of investment adviser? What would be the disadvantage of doing so?

2. Are there classes of investment advisers included in the definition of investment adviser that are not at risk, or present a very low risk for money laundering, terrorist financing, or other illicit activity such that they could appropriately be excluded from the definition? If so, why would it be appropriate to exclude such advisers from the definition as opposed to adopting an AML program that is appropriate to their level of risk?

3. Should foreign advisers that are registered or required to register with the SEC, but that have no place of business in the United States, be included in the definition of investment adviser?

4. To what extent are mid-sized, small, State-registered, and foreign private investment advisers that do not meet the definition of investment adviser proposed today at risk for being used for money laundering, terrorist financing, or other illicit activity?

5. Are there other types of investment advisers that may not meet the definition as proposed today, such as exempt reporting advisers ("ERAs") (whether the adviser is a U.S. or non-U.S. person), family offices, and financial planners, that are at risk for abuse by money launderers, terrorist financers, or other illicit actors?

6. With regard to ERAs, are there differences in the risks associated with an adviser that qualifies for and elects to use the 203(l) exemption from an adviser that qualifies for and elects to use the 203(m) exemption that would warrant different treatment under the BSA?

7. Are there certain types of financial planners that are not included in the proposed definition that, based on the activities in which they engage, are at risk for being used for money laundering, terrorist financing, or other illicit activity?

Proposed Requirement To Include Investment Advisers in the General Definition of Financial Institution and To Require Advisers To File CTRs and Comply With the Recordkeeping and Travel Rules

1. With regard to requiring investment advisers to comply with the Recordkeeping and Travel Rules and other related recordkeeping requirements and the anticipated impact of subjecting advisers to these requirements, what are the anticipated time and monetary

savings that could result from replacing the requirement to file reports on Form 8300 with a requirement to file CTRs?

2. Is there any information that law enforcement, tax, regulatory, and counter-terrorism investigations may possibly lose because investment advisers would be filing CTRs as opposed to filing Form 8300s?

Proposed AML Program Requirement

1. Is the proposed rule's approach of requiring an investment adviser to include in its AML program requirement all of the advisory services it provides, whether acting as the primary adviser or a subadviser, an appropriate approach?

2. Is the risk-based nature of the proposed AML program requirement sufficiently flexible to permit an investment adviser to develop and implement an AML program without providing specific exclusions for certain advisory activity?

Proposed Minimum Requirements of the AML Program

1. Is it appropriate to allow an adviser to delegate some elements of its compliance program to an entity with which the client, and not the adviser, has the contractual relationship?

2. Is it appropriate for FinCEN to expect an investment adviser to include in its AML program all advisory services that an adviser may provide to non-pooled investment vehicle clients (e.g., individuals and institutions), registered open-end fund clients, registered closed-end fund clients, private fund/other unregistered pooled investment vehicle clients, and wrap fee programs?

3. To what extent would a subadviser's AML program overlap with the primary adviser's AML program and how could any possible duplication of effort be mitigated?

4. Is there an increased risk for such a subadviser to be used for money laundering, terrorist financing, or other illicit activity when providing advisory services to a client that has a primary adviser that is not an investment adviser?

5. Should the primary adviser be required to apply the same approach when the investing pooled entity is a registered investment company, such as a mutual fund or closed-end fund?

6. Should a subadviser to a private fund or other unregistered pooled investment vehicle, which has a primary adviser that is not an investment adviser, be required to establish the same policies and procedures as when the primary adviser is an investment adviser?

7. If an underlying investor in the private fund or other unregistered pooled investment vehicle is an investing pooled entity, should a subadviser be required to identify risks and incorporate policies and procedures within its AML program to mitigate the risks of the

investing pooled entity's underlying investors, sponsoring entity, and/or intermediaries when there is an increased risk of money laundering, terrorist financing, or other illicit activity?

8. Is an express exclusion for advisory activity provided to an open-end or closed-end fund appropriate to reduce potential overlap or redundancy?

9. With respect to a mutual fund's omnibus accounts, are the money laundering or terrorist financing risks mitigated because the fund is required to assess the risks posed by its own particular omnibus accounts?

10. Should an adviser to a wrap fee program be required to obtain additional information about the investors in the program and/or coordinate its review with the sponsoring broker-dealer when the adviser sees an increased risk for money laundering, terrorist financing, or other illicit activity?

Proposed Suspicious Activity Reporting Rule

1. Should investment advisers be permitted to share SARs within their corporate organizational structure in the same way that banks, broker-dealers in securities, futures commission merchants, mutual funds, and introducing brokers in commodities are permitted to share? How would such sharing be consistent with the purposes of the BSA and how would investment advisers be able to maintain the confidentiality of shared SARs?

Future Consideration of Additional BSA Requirements for Investment Advisers

1. Should investment advisers be required to comply with other FinCEN rules implementing the BSA, including the rules requiring customer identification and verification procedures pursuant to section 326 of the USA PATRIOT Act and the correspondent account rules of section 311 and 312 of the USA PATRIOT Act?

2. Should investment advisers be required to comply with FinCEN rules implementing section 313 and 319(b) of the USA PATRIOT Act?

Regulatory Flexibility Act Questions

1. Please provide comment on any or all of the provisions in the proposed rule with regard to (a) the impact of provision(s) (including any benefits and costs), if any, in carrying out the requirements of the proposed rule(s) on investment advisers; and (b) alternative requirements, if any, FinCEN should consider.

2. Please provide comment regarding whether the AML program and suspicious activity reporting requirements proposed in these rulemakings would require small entities to gather any information that is not already being gathered as part of other regulatory requirements, due diligence, or prudential business practices and provide specific

example of such information.

Paperwork Reduction Act Questions

1. We seek comment on FinCEN's three-hour estimate for the establishment of an AML program per investment adviser. Is the estimate of three hours per year accurate and if not, what is a recordkeeping estimate that more accurately reflects the time an investment adviser would need to establish an AML program. We also seek comment regarding the estimated costs associated with establishing an AML program, specifically with regard to systems and labor costs.

2. We seek comment on FinCEN's annual three-hour estimate for the SAR recordkeeping and reporting requirement per investment adviser. Is the estimate of three hours per year accurate, and if not, what is a recordkeeping and reporting requirement estimate that more accurately reflects the time an investment adviser would need to fulfill the SAR recordkeeping and reporting requirement. We also seek comment regarding the estimated start-up costs and costs of operation to maintain SARs.

3. We seek comment on FinCEN's average annual estimate of one hour of recordkeeping and reporting per CTR per investment adviser. Is FinCEN's estimate of the burden of the proposed collection of information accurate? FinCEN seeks comment on whether the proposed collection of information is necessary for the proper performance of the mission of FinCEN, including whether the information will have practical utility. Are there ways to minimize the burden of the required collection of information, including through the use of automated collection techniques or other forms of information technology? Finally, FinCEN seeks comment regarding the estimated start-up costs and costs of operation, maintenance, and purchase of services to maintain the collected information.