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PERSPECTIVE

Proposed anti-money laundering rules focus on investment advisers

By Michael M. Farhang

U.S. law enforcement's ongoing campaign against international money laundering and terrorist financing has just crossed into new territory: the world of investment advisers. Last August, the Treasury Department's Financial Crimes Enforcement Network (FinCEN) issued a new proposed rule for comment that would subject investment advisers required to register with the Securities and Exchange Commission to the federal Bank Secrecy Act (BSA) and various other anti-money laundering laws. If the proposed rule is ultimately made final, it will require investment advisers to establish anti-money laundering compliance programs and engage in periodic reporting to FinCEN about suspicious activity involving their investors and the sources and uses of certain investments.

Although banks, mutual funds, insurance companies and investment broker-dealers have been subject to the BSA's anti-money laundering (AML) requirements for some time, asset management firms and investment advisers to pooled private investment funds like private equity and hedge funds have not. Since the 2010 Dodd-Frank Act, advisers to hedge funds and other private funds in certain categories have been required to register with the SEC under the Investment Advisers Act of 1940, and the new proposed rule will bring most investment firms with more than \$100 million in assets under management within the definition of "financial institution" subject to the BSA's requirements. This category represents a significant chunk of the global financial markets. According to FinCEN's estimates, as of June 2014, there were 11,235 SEC-registered investment advisers with approximately \$61.9 trillion in client assets.

FinCEN appears to have concluded that the significant burdens its new rule will impose on investment advisers are reasonable in light of the need to address potential AML risks posed by unregulated fund activities. The outlay that will be required to comply with the BSA may be large for some firms, especially smaller firms that do not already have some AML procedures in place. To comply with the BSA, investment advisers will be required to recruit and

hire qualified compliance personnel (including a designated AML officer), implement risk-based policies, procedures and internal controls, set up a system for independent periodic testing, and provide ongoing AML training for their personnel. In addition, investment advisers will need to establish record-keeping protocols and systems sufficient to allow them to flag, investigate and report suspicious activity involving amounts of at least \$5,000, as well as report certain currency-based transactions. In many cases, firms will need to hire outside experts and consultants to help them set up and maintain adequate compliance programs.

The proposed rule does not specify exactly how FinCEN believes investment advisers might be used to facilitate criminal activity, but the rule's accompanying comments note that investment advisers "may be at risk for attempts by money launderers or terrorist financiers seeking access to the U.S. financial system through a financial institution type not required to maintain AML programs or file suspicious activity reports." Despite having withdrawn a similar proposed rule covering investment advisers in 2008, FinCEN appears to be intent this time on finalizing a rule subjecting investment firms to BSA requirements, a step that will bring the U.S. into line with some other jurisdictions. The United Kingdom, for example, has already brought private equity firms within the purview of regulations subjecting them to AML compliance and reporting requirements.

FinCEN shows no signs of abandoning its rulemaking effort. The comment period for the proposed rule closed last November, the agency having disclosed that it received 33 comments. The American Bankers Association, a trade group representing the U.S. banking industry, submitted a comment in support calling the proposed rule "an appropriate step." In public remarks the same month, FinCEN director Jennifer Shasky Calvery emphasized the importance of closing the enforcement gap with the proposed rule and declared that investment advisers "are on the front lines of a multi-trillion dollar sector of our financial system [and that 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."

FinCEN's concerns about the threat of terrorist financing and money laundering in the financial industry are understandable given the risks the myriad ways in which ordinary banking and other financial transactions have been used to disguise or facilitate criminal activity. Investments in private equity and hedge funds appear at first blush, however, to be a poor target for money launderers in that investors' holdings tend to be fairly illiquid — funds deposited by limited partners with the fund are generally locked up for some period of time and not subject to redemption at will, and funds typically do not deal in cash. That a fund's limited partners must turn over their deposited investments to be managed by the fund's general partner and typically do not see those proceeds returned for some time might act as a deterrent to criminals or terrorists seeking a nimble and convenient money laundering vehicle.

Private equity and hedge fund structures nonetheless might still present some attractive features to criminal enterprises seeking to manipulate the financial system, especially given the rapid proliferation of such funds in recent years. Both structures typically deal in high-dollar investments — a single opening investment may be in the multiple millions of dollars — and entail some degree of opacity about the levels and sources of individual investor holdings. The largest hedge funds, for example, do not need to disclose in SEC filings all investors holding interests and smaller funds have even more limited disclosure obligations regarding their operations. In addition, some U.S.-based investment funds may maintain accounts overseas, offering investors the opportunity to move money across borders. Even though a banking institution that maintains the fund's accounts may itself have an AML program, that bank may not have the same opportunity to identify and scrutinize the investors that the fund's manager does, since the bank's customer is the fund and not necessarily each individual investor.

FinCEN is clearly concerned about situations in which criminal or terrorist enterprises could use shell companies or individuals as fronts in order to "park" proceeds with unsuspecting investment firms in order to keep the proceeds' origin or ultimate use hidden from law

enforcement authorities. Overseas drug cartels or corrupt foreign officials in possession of the fruits of illegal activity might try to use funds to house those monies offshore in a safe haven where they could be accessed later and even grow over time while remaining undetected or difficult to recover by their own governments. Terrorist organizations might seek to use funds to hold donor money that could supply a later source of funding for their activities. These scenarios, though hypothetical, are examples of the types of "gap" risks that FinCEN is likely seeking to address with its proposed regulation.

Affected firms will need to bring their AML compliance programs into working order within six months from the date of issuance of a final FinCEN rule, a task that promises to be a tall (and expensive) order for firms that have not implemented any such compliance programs to date. FinCEN has designated the SEC's Office of Compliance and Inspections and Examinations to monitor firms' adherence to the rule's requirements. Failure to comply with the BSA will carry the possibility for civil monetary penalties as well as potential criminal penalties.

Given the U.S. government's growing focus on the threats of terrorism and international money laundering, closing the regulatory gap through application of AML requirements to investment advisers will give law enforcement yet another powerful tool in the arsenal to fight such criminal activity in the financial sector. Investment advisers will need to get ready to gear up for the effort, as they are now considered, in the words of FinCEN, to be on the "front lines" of this struggle.

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