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Private Equity Alert

FinCEN Proposes AML Regulations for Registered Investment Advisers

BEA Subjects Investment Advisers and Other Financial Services Providers to Survey on Form BE-180

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FinCEN Proposes AML Regulations for Registered Investment Advisers

The Financial Crimes Enforcement Network (FinCEN), a bureau of the U.S. Department of the Treasury, recently proposed rules (the Proposed Rules) that would require registered investment advisers to adopt anti-money laundering (AML) programs and report suspicious activity to FinCEN pursuant to the Bank Secrecy Act (the BSA).[1] The Proposed Rules (which follow several prior unadopted proposals by FinCEN to apply AML rules to investment advisers and private funds) reflect FinCEN's belief that if not subject to AML regulations, investment advisers may be used by money launderers or terrorist financers to seek access to the U.S. financial system. Comments on the Proposed Rules are due on or before November 2, 2015, and we will continue to monitor developments as the rulemaking process progresses.

Investment Advisers Subject to the Proposed Rules

The Proposed Rules would apply to all advisers registered with the Securities and Exchange Commission (SEC), including those dually registered with the SEC as broker-dealers (or advisers affiliated with registered broker-dealers) and registered advisers located outside of the U.S.[2] However, the Proposed Rules do not cover advisers that file reports with the SEC as exempt reporting advisers. The Proposed Rules would include registered advisers as "financial institutions" under the BSA, and as a result the BSA's general reporting, recordkeeping and other requirements would apply, as more fully described below.

Proposed Rules

AML Programs

The Proposed Rules require each investment adviser to develop and implement a written AML program reasonably designed to prevent the adviser from being used to facilitate money laundering or the financing of terrorist

activities and to achieve and monitor compliance with the applicable provisions of the BSA and FinCEN's regulations. The AML program must be approved in writing by the adviser's board of directors (or similar body), and an adviser would be required to make its AML program available to FinCEN and the SEC upon request.

Scope of AML Program – FinCEN stated that the mandate to adopt an AML program is not a "one-size-fits-all" requirement. Instead, an adviser should take a risk-based approach and design its program to meet the specific risks of the advisory services it provides and the clients it advises. Accordingly, a small private equity fund manager's AML program will in all likelihood look very different (and generally will be simpler) than that of a diversified asset manager that offers many different products (*e.g.*, hedge funds, mutual funds, managed accounts). However, an adviser's AML program must cover all of its advisory activity, including any sub-advisory services.[3]

Addressing AML Risks for Private Funds – In developing its AML program, FinCEN stated that an adviser to private funds must analyze the money laundering and terrorist financing risks posed by a particular fund investor by using a risk-based evaluation of relevant factors. If the investor is an individual, the source of funds and the jurisdiction in which the investor is located, among other things, would be significant factors. If the investor is an entity, an adviser may consider the type of entity, the jurisdiction in which it is located, and the statutory and regulatory regime of that jurisdiction. The adviser's historical experience with the investor and the references of other financial institutions may also be relevant factors. As the risks posed by an investor increase, the adviser's policies, procedures, and internal controls will need to be reasonably designed to prevent the adviser from being used by the investor for money laundering or terrorist financing.

Generally, a private fund adviser should have access to information about the identities and transactions of its underlying investors. FinCEN noted that there may be a lack of transparency regarding the entities that invest in private funds, which may put private funds at greater risk for money laundering and other illegal activity.[4] However, under other circumstances, certain private funds may present lower risks for money laundering activity than other advisory clients. Consequently, FinCEN stated that it would not expect an adviser to risk-rate the advisory services it provides to a private fund that presents a lower risk the same as it might rate the advisory services it provides to other types of private funds that may present higher risks. An adviser must undertake the same risk-based analysis regardless of whether its private fund client is organized in the U.S. or offshore.

Delegation of Duties – FinCEN acknowledged that because an adviser's services may involve other financial institutions such as broker-dealers, banks or other investment advisers that have separate AML program requirements, some elements of the adviser's AML program may best be performed by personnel of these entities, in which case it is permissible for an adviser to delegate contractually the implementation and operation of those aspects of its AML program. However, any adviser that delegates the implementation and operation of aspects of its AML program to another financial institution, agent, third-party service provider or other entity will remain fully responsible for the effectiveness of the program, as well as for ensuring that FinCEN and the SEC are able to obtain information and records relating to the program.

Required Components of AML Program – Under the Proposed Rules, the four minimum requirements for an AML program are as follows:

1. *Establish and Implement Policies, Procedures, and Internal Controls* – The written AML program must establish and implement policies, procedures, and internal controls based upon the adviser's assessment of the money laundering or terrorist financing risks associated with its business. The policies, procedures, and internal controls should be reasonably designed to prevent the adviser from being used for money laundering or the financing of terrorist activities, and to achieve and monitor compliance with the applicable provisions of the BSA and FinCEN's regulations. Generally, an adviser must review, among other things, the types of advisory services it provides

and the nature of the clients/investors it advises to identify its vulnerabilities to money laundering and terrorist financing activities, and the adviser's policies, procedures, and internal controls must be developed based on this review.

2. *Provide for Independent Testing for Compliance to be Conducted by Company Personnel or by a Qualified Outside Party* – An adviser must provide for independent testing of its AML program on a periodic basis to ensure that it complies with FinCEN's requirements and that the program functions as designed. Employees of the adviser, its affiliates or unaffiliated service providers may conduct the independent testing, so long as those same employees are not involved in the operation and oversight of the program. The employees should be knowledgeable regarding BSA requirements. The frequency of the independent testing will depend upon the adviser's assessment of the risks posed. Any recommendations resulting from such testing should be promptly implemented or submitted to senior management for consideration.

3. *Designate a Person or Persons Responsible for Implementing and Monitoring the Operations and Internal Controls of the Program* – An adviser must designate a person or persons to be responsible for implementing and monitoring the operations and internal controls of the AML program. The person or persons should be knowledgeable and competent regarding FinCEN's regulatory requirements and the adviser's money laundering risks, and should have full responsibility and authority to develop and enforce appropriate policies and procedures to address those risks. Whether the compliance officer is dedicated full time to BSA compliance would depend on the size and type of advisory services the adviser provides and the clients it serves. A person designated as a compliance officer should be an officer of the adviser.

4. *Provide Ongoing Training for Appropriate Persons* – An adviser must provide for training of appropriate persons regarding the AML program. In order to carry out their responsibilities effectively, employees of an adviser (and of any agent or third-party service provider) must be trained in BSA requirements relevant to their functions and in recognizing possible signs of money laundering that could arise in the course of their duties. Such training may be conducted by outside or in-house seminars. The nature, scope, and frequency of the adviser's training program would be determined by the responsibilities of the employees and the extent to which their functions bring them in contact with BSA requirements or possible money laundering activity. Consequently, the training program should provide a general awareness of overall BSA requirements and money laundering issues, as well as more job-specific guidance regarding particular employees' roles and functions in the AML program. For those employees whose duties bring them in contact with BSA requirements or possible money laundering activity, the requisite training should occur when the employee assumes those duties, and employees should receive periodic updates regarding the AML program.

Suspicious Activity Reports (SARs)

The Proposed Rules would require advisers to report to FinCEN within 30 days of discovery suspicious transactions that are conducted or attempted by, at, or through the adviser and involve or aggregate at least $5,000 in funds or other assets.[5] Furthermore, an adviser may voluntarily report any transaction it believes is relevant to the possible violation of any law or regulation but that is not otherwise required to be reported. An adviser is required to report a transaction if it knows, suspects, or has reason to suspect that the transaction (or a pattern of transactions of which the transaction is a part): (i) involves funds derived from illegal activity or is intended or conducted to hide or disguise funds or assets derived from illegal activity; (ii) is designed, whether through structuring or other means, to evade the requirements of the BSA; (iii) has no business or apparent lawful purpose, and the adviser knows of no reasonable explanation for the transaction after examining the available facts; or (iv) involves the use of the adviser to facilitate criminal activity. FinCEN stated that the determination to file a SAR should be based on all the

facts and circumstances relating to the transaction and the client/investor in question.[6] A SAR and any information that would reveal the existence of a SAR are confidential and may not be disclosed by an adviser or its employees except as authorized by FinCEN regulations. The Proposed Rules provide protection from liability for making either required or voluntary reports of suspicious transactions, and for failures to disclose the fact of such reporting to the extent provided by FinCEN regulations.

Currency Transaction Reports (CTRs)

Investment advisers are currently required to file reports with FinCEN on Form 8300 for the receipt of more than $10,000 in cash and negotiable instruments. The Proposed Rules would replace this requirement with one that requires an adviser to file a CTR for a transaction involving a transfer of more than $10,000 in currency by, through or to the adviser during a single business day. An adviser must treat multiple transactions as a single transaction if it has knowledge that the transactions are conducted by or on behalf of the same person.

Recordkeeping and Travel Rules

The Proposed Rules would require advisers to create and retain records for transmittals of funds, and ensure that certain information pertaining to the transmittal of funds "travel" with the transmittal to the next financial institution in the payment chain. These "Recordkeeping and Travel Rules" apply to transmittals of funds that equal or exceed $3,000. Under the Proposed Rules, advisers would fall within an existing exception that is designed to exclude from these requirements' coverage transmittals of funds in which certain categories of financial institutions are the transmittor, originator, recipient, or beneficiary. The proposed application of the exception to advisers is intended to provide them with treatment similar to that of banks and broker-dealers. The Proposed Rules would also require advisers to create and retain records for extensions of credit and cross-border transfers of currency, monetary instruments, checks, investment securities, and credit. These requirements would apply to transactions in amounts exceeding $10,000.

Special Information Sharing Procedures to Deter Money Laundering and Terrorist Activity

The Proposed Rules also would subject advisers to FinCEN's regulations (which implement procedures to detect money laundering or terrorist activity required by the USA PATRIOT Act) regarding the sharing of information between the government and financial institutions and allow FinCEN to require advisers 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.

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1. The Proposed Rules can be found at http://www.fincen.gov/statutes_regs/frn/pdf/1506-AB10_FinCEN_IA_NPRM.pdf. While the Proposed Rules do not require advisers to adopt customer identification programs similar to those required of other financial institutions, FinCEN stated that it anticipates addressing these programs for advisers, as well as other AML issues, in subsequent rulemakings.
2. Under the Proposed Rules FinCEN would delegate to the SEC authority to examine registered advisers for compliance with FinCEN's regulations.
3. FinCEN specifically stated that advisers to real estate funds are not excepted from the Proposed Rules.
4. FinCEN noted that if an investor in a private fund is itself a private fund or some other type of pooled investment vehicle, the adviser will need to assess the money laundering or terrorist financing risks associated with the investing pooled entity using a risk-based approach.
5. For situations requiring immediate attention, such as suspected terrorist financing or ongoing money laundering schemes, advisers are required to notify the appropriate law enforcement authority immediately by telephone in addition to filing a timely SAR.
6. Suspicious activity observed in the subscription for private fund interests may include the use of money orders or travelers checks in structured amounts to avoid currency reporting requirements. A money launderer also could fund a subscription with multiple wire transfers from different accounts maintained at different financial institutions.

BEA Subjects Investment Advisers and Other Financial Services Providers to Survey on Form BE-180

The Bureau of Economic Analysis (BEA) of the U.S. Department of Commerce recently issued amended regulations relating to its 2014 Benchmark Survey of Financial Services Transactions Between U.S. Financial Services Providers and Foreign Persons on Form BE-180 (BE-180). The BE-180 is a survey conducted every five years that collects data on transactions between U.S. financial services providers and non-U.S. persons. Previously, only those U.S. financial services providers contacted by the BEA were required to file. ***However, the BEA now requires a filing from every U.S. financial services provider, regardless of whether such person is contacted by the BEA, if either its aggregate sales of financial services to, or its aggregate purchases of financial services from, non-U.S. persons were greater than $3 million during its 2014 fiscal year.***[1]

The BE-180 requires data by type of service, type of affiliation with the non-U.S. person and country. Under the BE-180, the definition of a financial services provider is very broad and includes, among others, commercial and investment banks, broker-dealers, credit card companies, insurance companies and investment advisers. Financial services include securities trading and underwriting, lending and custody of financial instruments, financial advisory or management services and credit card and credit-related services. ***A U.S. investment adviser to private equity, hedge and other private funds is considered a financial services provider and therefore may have to file a BE-180 based on management fees, performance fees and certain other types of compensation***[2] ***earned from client funds and portfolio companies domiciled outside the U.S. during the adviser's 2014 fiscal year.*** An adviser must also analyze any purchases of financial services from non-U.S. persons for purposes of determining whether a BE-180 filing is required.

Portfolio companies that are themselves U.S. financial services providers may have their own BE-180 filing obligation.

Information reported on the BE-180 is confidential and may be used only for analytical or statistical purposes. The BEA has stated that information filed on the survey cannot be presented in a manner that allows it to be individually identified without the filer's prior written permission, and cannot be used for purposes of taxation, investigation, or regulation.

While the original filing deadline was October 1, 2015, the BEA has granted an automatic extension until November 1, 2015 (December 1 if the filer was contacted by the BEA and meets other criteria). The BEA may grant additional extensions if a request is submitted by November 1. The BE-180 and accompanying instructions, a list of Frequently Asked Questions and additional information can be found on the BEA's website at http://www.bea.gov/ssb/be180/.

1. A U.S. financial services provider that was not contacted by the BEA and that does not exceed the $3 million threshold for either sales or purchases has no filing obligation. A U.S. financial services provider that was contacted by the BEA and that does not exceed either threshold must still file a portion of the BE-180.
2. An instruction to the BE-180 states that an adviser should not report management fees from U.S.-domiciled funds unless the fee is charged directly to a foreign investor of the U.S.-domiciled fund rather than the fund itself.

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