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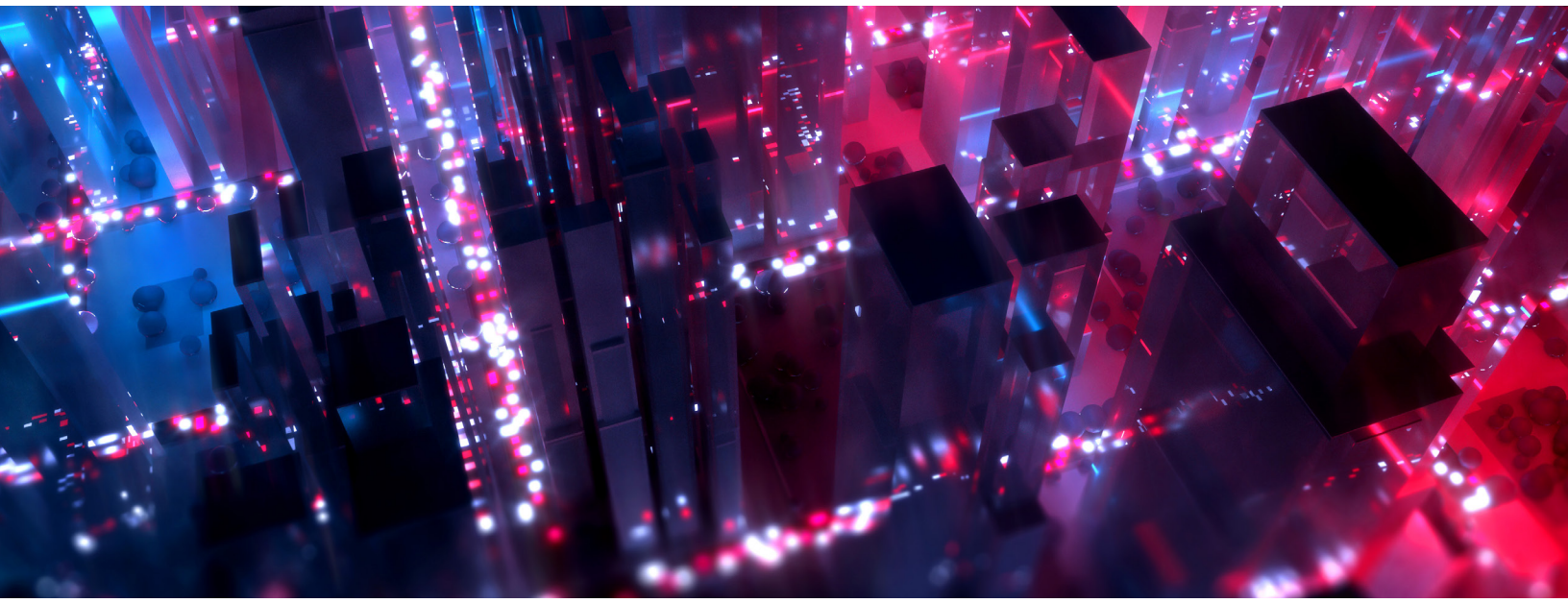
FinCEN Investment Adviser Rule FAQs

November 2024

What Investment Advisers ("IAs") Need to Know About the New AML/CFT Program Rules

On 28 August 2024, the Financial Crimes Enforcement Network (FinCEN) issued its Final Rulemaking ("Final Rule" to include certain investment advisers in the definition of a "financial institution" under the Bank Secrecy Act (BSA). The Final Rule subjects certain registered investment advisers (RIAs) and exempt reporting advisers (ERAs) to anti-money laundering and countering the financing of terrorism (AML/CFT) requirements pursuant to the BSA, including minimum standards for establishing AML/CFT programs, reporting suspicious activity to FinCEN, and fulfilling related BSA recordkeeping requirements. K2 Integrity has prepared Questions and Answers to assist IAs in understanding the applicability of the Final Rule's requirements and what IAs need to do to prepare for compliance with the new rule.



Q: Why has the Financial Crimes Enforcement Network ("FinCEN") determined the need to publish the IA Anti-Money Laundering ("AML")/Countering the Financing of Terrorism ("CFT") Final Rule and what must IAs consider in order to comply with the Final Rule?

Answer:

Although IAs are generally viewed as lower risk for AML and CFT risks, the Final Rule and 2024 Investment Adviser Risk Assessment ("the Assessment")[1] highlight several reasons why this Final Rule was issued, including the risk of sanctioned individuals, corrupt officials, tax evaders, and other criminal actors utilizing IAs to invest in U.S. securities, real estate, and other assets.

As the number of SAR filings associated with IAs as significantly increased since 2013, the U.S. government has developed a more detailed understanding of the illicit finance risks associated with the U.S. IA industry, including schemes perpetrated by sophisticated criminal networks, Russian oligarchs, and U.S. strategic competitors.[2] Based on analysis conducted, the Assessment highlights four main categories of illicit finance activity involving the IA sector in the United States:

1. Laundering of Illicit Proceeds Through IAs and Private Funds;
2. Russian Political and Economic Elites' Access to U.S. Investments;
3. Foreign State Actors That Could Use Investment Funds to Access Critical Infrastructure or Sensitive Technologies; and
4. IAs Defrauding Their Clients.

The Assessment provides detailed examples from these highlighted categories that are important for IAs to understand as they assess compliance with the Final Rule and consider how to identify and report suspicious activity to FinCEN. Further, this Final Rule improves the alignment of U.S. standards with international standards in accordance with which many countries, outside of the United States, already have AML/CFT rules in place for the IA sector.

With the issuance of the Final Rule, what should IAs do to assess readiness for compliance with the Final Rule?

Answer:

With the Final Rule now issued, and compliance required by January 1, 2026, the next step for IAs is to evaluate their current business operations, target client market, and business strategy to help identify where they may have heightened exposure to ML/TF risks. If the IA has an established risk appetite, this can assist in the evaluation, to identify areas of the business that will require increased due diligence and controls to effectively manage the risks going forward. Factors to consider in a risk assessment include the nature and purpose of the products and services offered, existing client base, delivery channels, higher risk geographies, geo-political exposure, and planned growth.

IAs should consider the following, non-exhaustive list, while assessing their risk profile:

1. What type of assets you are investing in and where are they formed (e.g., to identify both higher risk sectors and the potential involvement of countries deemed as secrecy havens or nontransparent countries)?
2. What are the AML/CFT regulatory requirements on broker dealers referring investors or assets to your firm?
3. Money movement in: who are the underlying funds coming from; where are investors located; their source of wealth ; are there potential sanctions or higher risk jurisdiction considerations; what is the nature and purpose of the investment?
4. Money movement out: where is the money going - Is it going into higher risk jurisdictions or intermediary countries to potentially evade sanctions or AML concerns; to counterparties unknown to the original investors or asset managers?
5. Do your investors deal only with reputable banks or service providers where you can leverage similar KYC information and documents that a regulated entity would obtain?

Examiners, now required to assess IAs' compliance with the Final Rule starting in 2026, will be looking for documentation supporting all aspects of the new requirements. Ensuring IAs first assess their risk and create appropriate risk-based AML/CFT programs, through policies, procedures, and risk governance activities will help in managing their AML/CFT risks and help keep the IAs in compliance with the Final Rule.

On the other hand, noncompliance can result in regulatory criticism, fines, and/or restrictions on business. IAs can face personal criminal penalties, including monetary fines, for willful violations of the BSA and its implementing regulations.

How Can K2 Integrity Help?

K2 Integrity can help IAs in evaluating the applicable risks to their business and help educate you and your board or senior management on the applicability of the Final Rule, the key risks in the industry, and assist you in determining whether you are inherently higher or lower risk for ML/TF activities. K2 Integrity does this through our vast knowledge of the BSA and accompanying rules and regulations, intimate knowledge of the IA sector, and years of experience leading other financial institution sectors in implementing and building risk-based AML/CFT programs that focus on actual risk.

Q: Which Investment Advisers are required to comply with the Final Rule?

Answer:

The Final Rules does not include all IAs but rather applies only to the following types of entities—unless they are subject to an exclusion, as discussed below—with registration or reporting requirements with the Securities and Exchange Commission ("SEC"):

- IAs registered with or required to register with the SEC, also known as Registered Investment Advisers ("RIAs"); and
- IAs that report to the SEC as exempt reporting advisers ("ERAs").[3]

Q: Which Investment Advisers are excluded from the Final Rule?

Answer:

The Final Rule specifically excludes from the definition of "investment adviser":

- RIAs that do not manage clients' assets as part of their advisory activities and are not required to report any assets under management ("AUM") to the SEC on Form ADV;
- RIAs that register with the SEC solely because they are (i) mid-sized advisers, (ii) multi-state advisers, or (iii) pension consultants;
- State-registered investment advisers;
- Foreign private advisers as defined in section 202(a)(30) of the Advisers Act;[4] and
- Family offices as defined in rule 202(a)(11)(G)-1 under the Advisers Act.[5]

How Can K2 Integrity Help?

K2 Integrity can assist IAs via our Strategic Advisory Services. We have seasoned veterans from the regulatory industry who can breakdown the complexity imbedded and help educate IAs and their senior management and Boards on the applicability of the Final Rule to your firms. Additionally, we can help advise on definitions of all exemptions including those of mid-sized advisor, multi-state advisor, or pension consultants that are excluded from the Final Rule

What are the Final Rule requirements that IAs must implement to comply?

Answer:

The Final Rule will require certain RIAs and ERAs to:

1. Implement a reasonably designed, risk-based AML/CFT program, to include internal policies, procedures, and controls reasonably designed to identify and prevent the IA from being used for AML/CFT or other illicit finance activity. These include:
    a. Internal policies for conducting initial and ongoing customer due diligence ("CDD") and enhanced due diligence ("EDD"). In determining which internal policies, procedures, and controls to implement, the Final Rule requires IAs to review the types of advisory services they provide and the nature of the customers they advise in order to understand their particular ML/TF and other illicit finance risks.
        i. CDD must include: (i) understanding the nature and purpose of customer relationships in order to develop a customer risk profile; and (ii) conducting ongoing monitoring to both identify (and report) potentially suspicious transactions and maintain (and update) customer information.
        ii. EDD should be performed on higher risk individuals/entities identified through the risk assessment process.
        iii. Additionally, IAs will need to go beyond the fund level and down to investors, on a risk basis, for the private funds they advise. FinCEN has highlighted the risks with private funds and how IAs should collect sufficient information to understand relevant investors and/or intermediaries and be able to detect and report suspicious activity.
    b. Independent testing of their AML/CFT programs;[6]
    c. Designation of an AML/CFT compliance officer; and
    d. Ongoing employee training program.
2. File certain reports, specifically:
    a. Suspicious Activity Reports ("SARs") to FinCEN;[7]
    b. Currency Transaction Reports ("CTRs") for receipt of more than $10,000 in currency[8] and certain negotiable instruments;[9] and
    c. Foreign Bank and Financial Accounts ("FBAR") reports.

3. Maintaining records such as those relating to the transmittal of funds (i.e., comply with the Recordkeeping and Travel Rules);[10]
4. Apply information-sharing provisions between and among FinCEN, law enforcement, government agencies, and certain financial institutions (i.e., sections 314(a) and 314(b) of the USA PATRIOT Act); and
5. Fulfill other obligations applicable to financial institutions subject to the BSA and FinCEN's implementing regulations, including special due diligence requirements for correspondent and private banking accounts (Section 312) and special measures under section 311 of the USA PATRIOT Act and Section 9714(a) of the Combatting Russian Money Laundering Act.

How Can K2 Integrity Help?

K2 Integrity can assist IAs by developing or enhancing AML/CFT policies and programs to meet new Final Rule requirements through the development and documentation of policies, procedures, controls for all aspects above, including education, training, and Board and senior management reporting. K2 Integrity can also assist IAs in developing or enhancing its independent testing framework to evaluate the IAs pertinent internal controls and processes. It is important to note that the independent testing requirement must be fulfilled by personnel independent of the function being tested.

Many IAs have an existing compliance officer; can the compliance officer also be the AML officer?

Answer:

The Final Rule requires that an investment adviser designate a person or persons to be responsible for implementing and monitoring the operations and internal controls of the AML/CFT program. Further, the Final Rule states that the person designated as the AML/CFT compliance officer should be an officer of the investment adviser (or individual of similar authority within the particular corporate structure of the investment adviser) with established channels of communication with senior management, sufficient independence and access to resources to implement a risk-based and reasonably designed AML/CFT program.[11] An existing compliance officer can also take on responsibilities of the AML/CFT program; however, the expectation within the requirement is that an AML/CFT compliance officer is qualified to oversee the IA's compliance with the Final Rule. Firms should ensure that the individual is not only qualified but also has appropriate subject matter expertise, resources, time, and funding to effectively take on the new responsibilities.

How Can K2 Integrity Help?

Although K2 Integrity cannot perform the function of the AML/CFT Officer due to the Final Rule requiring this function be performed by an employee of the IA, K2 Integrity can provide education and training and perform staffing assessments to ensure you are meeting your obligations and expectations of the AML/CFT compliance officer role as part of the Final Rule.

Q: Many IAs have voluntary know-your-customer ("KYC") and/or due diligence processes in place. Should IAs covered by the Final Rule be required to make any changes to their current processes?

Answer:

Regardless of the breadth or depth of current policies and procedures in place, any IA that has yet to be subject to direct examination and supervision for these requirements should undertake a complete risk assessment in order to identify any potential gaps in the program. The obligations of the Final Rule are far broader than KYC or CDD and include understanding and documenting, for each investor/account, the nature and purpose of the investor/account, source of funds, and source of wealth and filing SARs to FinCEN for AML/CFT activity. As such, it is imperative that IAs perform independent assessments of their current AML/CFT programs and underlying process in place to identify potential enhancements required under the Final Rule. The independent gap assessment can be performed in-house by legal or compliance functions, or IAs may choose to hire an independent consulting firm skilled in AML/CFT program assessments.

How Can K2 Integrity Help?

K2 Integrity can perform a gap assessment of your entire AML/CFT program to ensure your AML/CFT program meets all of the additional requirements set forth in the Final Rule. There are several activities required under the Final Rule that go above and beyond the voluntary KYC/due diligence programs the IA sector has implemented to date, including compliance with the legal requirement to file SARs and respond to 314(a) requests and the application of EDD for higher-risk clients.

Q: Can IAs outsource certain, or all, activities? What should IAs consider in determining what activities to retain in house vs. outsourcing?

Answer:

Yes, IAs may retain a third-party, including a third-party based abroad, to assist with the portions or all aspects of its AML/CFT program. Many IAs, particularly small to mid-size firms, likely leverage third parties to perform certain AML/CFT functions, including those that are now explicit requirements under the Final Rule. However, the Final Rule specifically states that IAs are "fully responsible and legally liable" for the AML/CFT program. IAs who solely rely on a third-party service provider with no oversight are at risk of noncompliance. This includes IAs who utilize Reliance Agreements[12] for Customer Identification Programs ("CIP") or other contracts outlining the responsibilities of the provider.

IAs will need to provide information and records relating to its AML/CFT program to FinCEN and the SEC; therefore, IAs should assess their current third-party relationships to assess whether current vendors are consistent with FinCEN's and the SEC's expectations and determine what additional steps need to be taken to fully adhere to the new Final Rule. IAs should expect to know all aspects of what the third party is performing on their behalf, evidence this understanding, and ensure proper governance and reporting is in place to effectively manage the third-party activities. The Final Rule expressly states that "it would not be sufficient to simply obtain a certification from a service provider that the service provider 'has a satisfactory anti-money laundering program.'"[13]

Additionally, when evaluating an appropriate party to perform the required independent testing function, IAs may choose to leverage existing third parties for this work; however, it is imperative that such parties are truly 'independent,' meaning that they must be performed by personnel independent of the function being tested, even if they are nonetheless employees of the same IA or qualified outside party.

How Can K2 Integrity Help?

K2 Integrity can assist IA's by developing proper oversight and governance over third-party service providers and/or affiliates, including broker-dealer and custodial arrangements.

Does the Final Rule apply to IAs affiliated with a bank or broker-dealer?

Answer:

Yes. The Final Rule specifies that IAs are subject to the requirements of the Final Rule, even if the IA is dually registered as a broker-dealer or is a bank (or is a bank subsidiary). However, such IAs need not establish separate AML/CFT programs so long as a comprehensive AML/CFT program covers all of the IA's relevant advisory activities. In addition, an IA affiliated with, or a subsidiary of, another entity required to establish an AML/CFT program will not be required to implement multiple or separate programs and instead may elect to implement one enterprise program for all affiliated entities, so long as such AML/CFT program is designed to identify and mitigate the different AML/CFT, and other illicit finance activity risks posed by each affiliate's (or subsidiary's) business(es) and satisfies each of the risk-based AML/CFT program and other reporting requirements to which the entities are subject.

How Can K2 Integrity Help?

K2 Integrity can assist IAs by performing a risk assessment and gap analysis to determine which IAs need to establish a program and where an enterprise program may be suitable, as well as to develop proper oversight and governance over third-party service providers and/or affiliates, including broker-dealer and custodial arrangements.

How should IAs manage expectations with the additional related pending rulemakings that are yet to be issued?

Answer:

The Final Rule expressly provides that an IA would not be considered a "covered financial institution" for the purposes of the CDD Rule, given that the requirement to identify and verify the beneficial owners of legal entity customers is predicated on the existence of a CIP requirement, which under the BSA must be prescribed jointly with the relevant federal functional regulator (in this case, the SEC). FinCEN has therefore announced its intention to address CIP requirements through a future joint rulemaking with the SEC (issued as a Notice of Proposed Rulemaking on May 13, 2024) and to address the requirement to collect and verify beneficial ownership information for legal entity customers through a separate future rulemaking.[14] Nonetheless, IAs should monitor the pending rules, consider the impacts of the following two pending proposed rules, and, where feasible, incorporate them into their AML/CFT programs preemptively to avoid delays and costly implementation challenges at a later date:

- **Customer Identification Program Rule**

  The CIP Rule implements section 326 of the USA PATRIOT Act of 2001 and requires banks, savings associations, credit unions, and certain non-federally regulated banks to have a customer identification program.

- **Customer Due Diligence Rule**

  The CDD Rule sets forth requirements for the collection and verification of beneficial ownership information of legal entity customers, among other requirements.

How Can K2 Integrity Help?

K2 Integrity can assist IAs in identifying your risks early on and determining where implementing risk-based controls help appropriately manage your risks; this includes making a risk-based determination as to whether you should proactively collect customer identification and/or beneficial ownership information based on the customer's risk profile to help manage any potential reputational risk concerns.

ENDNOTES

1. https://home.treasury.gov/system/files/136/US-Sectoral-Illicit-Finance-Risk-Assessment-Investment-Advisers.pdf.
2. Federal Register, Vol. 89, No. 32 (February 15, 2024), p. 12116, available at: https://www.govinfo.gov/content/pkg/FR-2024-02-15/pdf/2024-02854.pdf.
3. An ERA is an investment adviser that would be required to register with the SEC but is statutorily exempt from such requirement because: (1) it is an adviser solely to one or more venture capital funds; or (2) it is an adviser solely to one or more private funds and has less than $150 million AUM26 in the United States.27 Even though they are not required to register, ERAs must still file an abbreviated Form ADV with the SEC, and the SEC maintains authority to examine ERAs. Form ADV uses the term "regulatory assets under management" (RAUM) instead of "assets under management." Form ADV describes how advisers must calculate RAUM and states that in determining the amount of RAUM, an adviser should "include the securities portfolios for which [it] provide[s] continuous and regular supervisory or management services as of the date of filing" the form. See Form ADV, Instructions for Part 1A, Instruction 5.b
4. The term "foreign private adviser" means any investment adviser who: (A)has no place of business in the United States; (B)has, in total, fewer than 15 clients and investors in the United States in private funds advised by the investment adviser; (C)has aggregate assets under management attributable to clients in the United States and investors in the United States in private funds advised by the investment adviser of less than $25,000,000, or such higher amount as the Commission may, by rule, deem appropriate in accordance with the purposes of this subchapter; and (D)neither— (i)holds itself out generally to the public in the United States as an investment adviser; nor (ii)acts as— (I)an investment adviser to any investment company registered under the Investment Company Act of 1940 [15 U.S.C. 80a–1 et seq.]; or (II)a company that has elected to be a business development company pursuant to section 54 of the Investment Company Act of 1940 (15 U.S.C. 80a–53), and has not withdrawn its election.
5. A family office is a company (including its directors, partners, members, managers, trustees, and employees acting within the scope of their position or employment) that: (1) Has no clients other than family clients; provided that if a person that is not a family client becomes a client of the family office as a result of the death of a family member or key employee or other involuntary transfer from a family member or key employee, that person shall be deemed to be a family client for purposes of this section for one year following the completion of the transfer of legal title to the assets resulting from the involuntary event; (2) Is wholly owned by family clients and is exclusively controlled (directly or indirectly) by one or more family members and/or family entities; and (3) Does not hold itself out to the public as an investment adviser.
6. This can be performed by the IA's personnel or a qualified outside party; but must be independent from the personnel performing the function being tested.
7. The Final Rule requires IA's to file a SAR with FinCEN for any suspicious transaction (or pattern of transactions) conducted or attempted by, at or through the AI that involves or aggregates at least $5,000 in funds or other assets.
8. The coin and paper money of the United States or of any other country that is designated as legal tender and that circulates and is customarily used and accepted as a medium of exchange in the country of issuance. Currency includes U.S. silver certificates, U.S. notes and Federal Reserve notes.
9. The CTR filing obligation replaces the obligation to file a Form 8300.
10. Any transmittor's financial institution or intermediary financial institution located within the United States shall include in any transmittal order for a transmittal of funds in the amount of $3,000 or more, information
11. Federal Register, Vol. 89, FR 72193 https://www.federalregister.gov/d/2024-19260/page-72193
12. Reliance Agreements are allowed for Customer Identification Program requirements per 31 CFR 1020.220(a)(6).
13. https://www.federalregister.gov/documents/2024/09/04/2024-19260/financial-crimes-enforcement-network-anti-money-launderingcountering-the-financing-of-terrorism, at 72188.
14. Independent of the investment adviser final rule, FinCEN intends to amend the CDD Rule to bring it into alignment with the Corporate Transparency Act of 2021.