JACKO LAW GROUP, PC

Legal Risk Management Tip
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Anti-Money Laundering as Applied to Investment Advisers

If you ever find yourself in a room full of investment advisers and are in need of a conversation starter, ask the following question: "Who believes that anti-money laundering ("AML") regulations don't apply to investment advisers?" The likely outcome will be a spirited debate with some taking the position that AML regulations do not apply to investment advisers, only to broker-dealers, while others may argue that AML safeguards are part of their fiduciary duty as an investment adviser and therefore there is an obligation to develop AML procedures.

The answer to the question is the focus of this article and will discuss current anti-money laundering regulations, duties owed by investment advisers and the anticipated changes that may be occurring in this area in the not-too- distant future.

Anti-Money Laundering ("AML") Regulations

Money laundering is the act of concealing the true origin of unlawfully derived funds so that the unlawful proceeds appear to have derived from legitimate origins or constitute legitimate assets.[1] Terrorist financing and drug trafficking tend to receive the most publicity, however, money laundering occurs in connection with a wide variety of crimes such as securities and other fraud, insider trading, market manipulation and racketeering. Combating money laundering is currently one of the greatest focuses of the U.S. government, and is leading to the proposal of new legislation.

Currently, AML program requirements for "financial institutions" are laid out in various laws including the Bank Secrecy Act of 1970 ("BSA"),[2] the Money Laundering Control Act of 1986, and most recently the USA PATRIOT Act ("USAPA").[3] These laws require "financial institutions" to establish AML programs that must include, among other things:

- Designation of an AML compliance officer,
- Written policies and procedures reasonably designed to detect, identify and report AML transgressions,
- AML employee training program, and
- Independent testing of AML policies and procedures.

To be clear, investment advisers are not expressly included within the definition of "financial institutions" under the BSA[4] or USAPA,[5] and as such, are not technically subject to the affirmative AML requirements of those regulations.

[1] Black's Law Dictionary 1097 (9th ed. 2009).
[2] Initially adopted in 1970, BSA establishes the basic framework for AML obligations imposed on "financial institutions."
[3] Enacted by Congress in 2001 in response to the September 11, 2001 terrorist attacks, USAPA places heightened responsibilities on businesses who work with securities and the public, such as banks and broker-dealers.
[4] *See* 31 U.S.C. § 5312 - Definitions and Application
[5] *See* http://www.gpo.gov/fdsys/pkg/PLAW-107publ56/pdf/PLAW-107publ56.pdf

The rationale behind excluding investment advisers from this definition is such that "investment advisers must conduct financial transactions for their clients through other financial institutions that are subject to BSA requirements, and their clients' assets must be carried at these other financial institutions."[6] Thus, the idea is that since investment advisers are already indirectly participating in AML policies and procedures via their relationship with other "financial institutions," their inclusion in this definition is somewhat repetitive.

Duties of Investment Advisers

The fact that investment advisers are not included in the formal definition of "financial institutions" does not mean advisers may ignore money laundering risks, or that they are not subject to any AML legal requirements.

A. Office of Foreign Assets Control

Since the passage of the USAPA, the Office of Foreign Assets Control ("OFAC"), which is an office of the US Department of Treasury, has provided regulatory obligations for financial institutions, *including* investment advisers with which to comply. OFAC is responsible for administering and enforcing economic and trade sanctions against certain targeted foreign countries that are known for money laundering, harboring terrorists, allowing international drug trafficking and permitting persons to facilitate the proliferation of weapons of mass destruction. As such, OFAC is charged with imposing controls on transactions and freezing assets under U.S. jurisdiction. OFAC regulations set forth certain requirements for investment advisers to block the accounts of specified countries, entities and individuals. For investment advisers, OFAC recommends establishing and maintaining an effective, risk-based OFAC compliance program.[7] Failure to do so could result in an enforcement action, particularly if the adviser has weak internal controls.[8]

B. SEC Expectations

Pursuant to federal securities laws,[9] the SEC has the authority to examine broker-dealers, investment companies, investment advisers, and other securities industry participants for compliance with federal securities laws, and to take enforcement action for violations of such laws. As mentioned above, such securities laws include anti- money laundering regulations found in the BSA and USAPA. As such, the SEC has the authority to request proof evidencing how securities industry participants, including investment advisers, are complying with federal securities law.

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[6] Federal Register Financial Crimes Enforcement Network; Withdrawal of the Notice of Proposed Rulemaking; Anti-Money Laundering Programs for Investment Advisers. Vol. 73, No. 214. November 4, 2008.

[7] Per OFAC, compliance programs should focus on the client acceptance process, which includes performing a check of each potential client against the OFAC list of "Specifically Designated Nationals and Blocked Persons ("SDN") (which may be found at http://www.treas.gov/ofac), to ensure the potential client is not on the OFAC SDN list; and regularly checking the Financial Action Task Force ("FATF") lists and accompanying narrative information to make sure that no client or potential client is located in or transacting business with any country identified by FATF (this information can be found at http://www.fatf-gafi.org). Note: OFAC does not require other AML program requirements set forth for broker-dealers and other financial institutions.

[8] In its enforcement guidelines, OFAC has stated that it may consider the "existence, nature and adequacy of a [firm's] risk- based OFAC compliance program" in determining whether to bring an enforcement action and the amount of any penalty imposed. *Please see*: http://www.gpo.gov/fdsys/pkg/FR-2009-11-09/html/E9-26754.htm.

[9] "Federal securities laws" generally means the Securities Act of 1933, the Securities Exchange Act of 1934, the Sarbanes- Oxley Act of 2002, the Investment Company Act, the Advisers Act of 1940, the Gramm-Leach-Bliley Act, and any rules adopted thereunder by the Commission or the Department of the Treasury.

Despite there being no specific requirement for an adviser to develop an AML program, SEC officials may inquire about a registrant's AML practices during exams, citing that as a fiduciary, investment advisers should consider ways in which it can further safeguard client assets and protect the integrity of the U.S. financial system. If the adviser has developed an AML policy, it is recommended that such protocols be memorialized in writing and periodically tested for effectiveness. Factors such as the firm's operations, nature and location of clients, relationships with third parties, and applicability of AML rules in non-U.S. jurisdictions all should be considered when developing any AML policy.

C. Broker-Dealer Reliance

While not required, often broker-dealers will request an advisory firm to perform certain AML procedures for which the broker may rely upon for its own AML program. In January of 2015, the SEC, in consultation with FinCEN, released a No-Action Letter[10] which extended a previous line of no-action letters permitting broker- dealers to rely upon[11] registered investment advisers[12] to perform certain customer identification aspects of the broker-dealer's Customer Identification Program ("CIP").[13] Delegation of this responsibility is typically captured as part of a reliance agreement, or similar document, whereby the duties of the adviser are defined and the adviser must agree to: (i) implement its own AML program consistent with the requirements of 31 U.S.C. 5318(h); (ii) perform the specified requirements of the broker-dealer's CIP Program in accordance with Section 326 the USAPA; (iii) promptly disclose to the broker-dealer potentially suspicious or unusual activity detected as part of the CIP Program and either file, or assist the broker-dealer in filing, a SARs as needed; (iv) certify annually to the broker-dealer that the representations in the reliance agreement remain accurate; and (v) maintain required books and records and make such records available upon request.[14]

Industry Trends Regarding AML Regulations for Investment Advisers

Due to the nature of activities engaged in by investment advisers, FinCEN has tried for over a decade to implement rules imposing AML regulations on investment advisers. In May of 2003, FinCEN published a notice of proposed rulemaking in the Federal Register[15] proposing that investment advisers establish anti-money laundering programs.[16] However, this proposal was withdrawn in 2008 due to a lack of any further regulatory action on behalf of FinCEN.

As a result of the regulatory changes following the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), FinCEN announced in 2011[17] that it would be revisiting its 2003 proposal requiring investment advisory firms to establish AML programs.

[10] *See* Request for No-Action Relief Under Broker-Dealer Customer Identification Program Rule (31 C.F.R. § 1023.220), SEC Staff No-Action Letter (Jan. 9, 2015) available at: http://www.sec.gov/divisions/marketreg/mr-noaction/2015/sifma- 010915-17a8.pdf

[11] According to a 2015 SEC no-action letter, a broker dealer may rely on an investment adviser to perform its CIP obligations if: (i) the broker-dealer's reliance on the investment adviser is reasonable under the circumstances; (ii) the investment adviser is an investment adviser registered with the SEC under the Investment Advisers Act of 1940; and (iii) the investment adviser enters into a contract with the broker-dealer outlining its AML responsibilities.

[12] Per the SEC No-Action Letter, such investment advisers must be registered with the SEC.

[13] A broker-dealer must establish, document, and maintain a written Customer Identification Program ("CIP") as part of its AML compliance program that is appropriate for its size and business and that, at a minimum, includes the name, date of birth, address and identification number.

[14] See Request for No-Action Relief under Broker-Dealer Customer Identification Program Rule (31 C.F.R. § 1023.220), SEC Staff No-Action Letter (Jan. 9, 2015).

[15] *See* http://www.fincen.gov/statutes_regs/frn/pdf/352investmentadvisers_fedreg050503.pdf

[16] *See* http://www.fincen.gov/news_room/speech/pdf/20111115.pdf

[17] *Id.*

Current FinCEN Director, Jennifer Calvery, reiterated this intention[18] when she stated that FinCEN "has been working closely" with the SEC on a new rule "that would impose an AML program and suspicious activity reporting ("SAR") requirements on investment advisors."[19] These remarks were further promulgated by David Cohen, undersecretary of Treasury for terrorism and financial intelligence, during a speech[20] given in Washington, D.C. recently whereby Mr. Cohen stated that "FinCEN, in consultation with the SEC, is working to define SEC-registered investment advisers as financial institutions and, because of their unique insight into customer and transaction information, to extend AML program and suspicious activity reporting requirements to them." Mr. Cohen went on to state that "this effort is already underway" implying that such reforms may be occurring sooner rather than later.

Anticipated AML Regulations / Considerations for Advisers

As mentioned above, while investment advisers are not currently required to develop AML policies pursuant to the BSA or USAPA, many have done so based on the requests set forth by OFAC, as a compliance "best practice," or at the request of a broker-dealer. While these advisers will have a head start on any new regulations, they might have to adjust those policies to meet the contours of any new rules once implemented.

For those advisers who have not yet implemented AML procedures, now is the time to start the process. While it's unclear exactly how the new regulations will appear, they will most likely mirror those regulations imposed on broker-dealers and other "financial institutions." As such, advisers developing AML programs should start by conducting a risk assessment to evaluate potential money laundering risk exposure inherent to their business. Considerations should be given to the specific risks of the firm including its customers, products and services.

Once these risks have been identified, an appropriate AML program can be developed to mitigate these risks. While each AML program should be tailored to the firm's specific risk factors, Section 352 of USAPA requires these programs include, at the very least, the following:

1. Designation of an internal AML compliance officer;
2. Written policies and procedures reasonably designed to detect, identify and report AML transgressions, including a Know Your Customer ("KYC") program designed to identify prospective clients and the source of their assets;
3. Ongoing employee training on the firm's AML program; and
4. An independent audit to test and maintain the adequacy and efficiency of the firm's AML program.

Conclusion

It is imperative that investment advisers have a detailed knowledge of how money laundering originates and the implications and risks inherent to their business. Those advisers who currently do not employ a formal AML policy as part of their Policies and Procedures Manual should consider incorporating such a policy, or at the very least, draft policies to specifically address the OFAC program. Advisers already incorporating AML policies should review and routinely test their processes to ensure they are effective. Taking these steps now will allow firms to stay ahead of the curve to prepare for the forthcoming regulations and to meet their ongoing fiduciary obligations to clients.

[18] *See* http://www.fincen.gov/news_room/speech/pdf/20130227.pdf.
[19] *Id.*
[20] *See* http://www.treasury.gov/press-center/press-releases/Pages/jl2692.aspx

For more information on these and other considerations, please contact us at (619) 298-2880 or at info@jackolg.com.

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