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Corporate & Finance Alert

March 20, 2024

An overview of the new proposed FinCEN AML/CFT Rules and their impact

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If adopted, investment advisers will have to implement and maintain strict compliance programs.

What's the impact?

- The potential for additional compliance burdens on registered investment advisors and exempt reporting advisers, including implementing compliance programs and knowing the identities of their investors.
- Updates may be needed to fund limited partnership agreements and offering documents, including the associated risk factors, depending on the language already included.
- This is part of a series of new rules that allow the United States government to gather more data on investors than ever before—mainly due to concern with Chinese and Russian investors gaining access to sensitive information and emerging technology.

What is the newest proposed rule impacting RIAs and ERAs, and why is it being issued?

On February 13, 2024, the Financial Crimes Enforcement Network (FinCEN), a division of the United States Treasury Department, proposed a new rule, Anti-Money Laundering (AML) / Countering the Financing of Terrorism (CFT) Program and Suspicious Activity Report Filing Requirements for Registered Investment Advisers and Exempt Reporting Advisers,[1] to promulgate additional AML rules under the Bank Secrecy Act (BSA)[2] targeting registered investment advisors (RIAs) and exempt reporting advisers (ERAs), each as defined under the Investment Advisers Act (the Advisers Act).[3]

Under the proposed rules, FinCEN would add RIAs and ERAs to the definition of a "financial institution"[4] under the BSA regulations governing internal risk controls for AML and CFT. The majority of advisers are currently not required to meet or maintain industry standard AML/CFT compliance programs. Accordingly, expanding the definition of a "financial institution" to include RIAs and ERAs will require these advisers to conduct a review of their current AML/CFT programs (if any) and bring them into parity with the rest of the financial industry.

Currently, in the United States, there are no federal or state regulations requiring investment advisers to maintain AML/CFT programs under the BSA, as they do not fall under the definition of "financial institution." Although some investment advisers may do so, for example, if they are also licensed as banks (or are bank subsidiaries), registered as broker-dealers, or advise mutual funds. Thousands of investment advisers overseeing the investment of trillions of dollars into the US economy currently operate without legally binding AML/CFT obligations.[5]

The United States Treasury Department conducted a risk assessment of the investment adviser sector that identified several illicit finance and national security risks. The risk assessment found several cases in which sanctioned individuals, corrupt officials, tax evaders, and other criminal actors have used investment advisers as an entry point to invest in US securities, real estate, and other assets. The risk assessment also identified cases of foreign adversaries, including China and Russia, investing in early-stage companies through investment advisers to access sensitive information and emerging technology.[6]

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[1] FinCEN Notice of Proposed Rulemaking, February 13, 2024; 89 Fed. Reg. 12108 (February 15, 2024).

[2] Bank Secrecy Act of 1970, 31 U.S.C. § 5311 *et seq.*; as delegated by the Secretary of the Treasury, pursuant to Treasury Order 180–01, paragraph 3(a) (Jan. 14, 2020).

[3] Investment Advisers Act of 1940, 15 U.S.C. § 80b-1 *et seq.*

[4] 31 CFR § 1010.100(t).

[5] 89 Fed. Reg. 12108 (February 15, 2024).

[6] *Id.* at 12117.

When will the new proposed rule be finalized?

The proposed rule is ***not*** final, and FinCEN is accepting comments until April 15, 2024, at which point they will decide to publish a final rule (likely with some updates), not pursue finalization, or re-open the comment period. If finalized, the compliance date would be twelve (12) months from the effective date.[7]

Who does the proposed rule apply to, and what are the key provisions?

The key provisions of the proposed rule are:

- All RIAs and ERAs, including those physically located outside of the United States, will be considered "***financial institutions***" under the BSA.
- By becoming a "***financial institution,***" RIAs and ERAs will be required to:
  - Implement an internal risk-based AML/CFT program that includes written policies and procedures for ongoing customer due diligence (CDD).
  - Designate an AML/CFT compliance officer.
  - Implement employee training programs.
  - Retain the services of independent auditors to test their AML/CFT program.
  - Maintain certain records relating to the transmittal of funds for transactions that exceed $3,000 per the BSA and report any transaction of more than $10,000 in one day.
  - Notify law enforcement and FinCEN of suspicious transactions (individually or in the aggregate) of at least $5,000 that indicate money laundering and terrorist financing activities are afoot within thirty (30) days of initial detection. These reports, known as Suspicious Activity Reports (SARs), place a ***mandatory duty*** on RIAs and ERAs to report suspicious activity, like structuring and other abnormal activities. If an investor transaction, now or in the future, raises suspicion of active money laundering or terrorism financing, then the firm must immediately contact federal law enforcement by telephone and cooperate fully with any accompanying investigations. This duty would require, among other things, RIAs and ERAs to monitor wire activity, including funding sources and destinations, requests for portfolio company information, activities that indicate a customer is acting as a proxy for a third party, or activities indicative of insider trading or market manipulation. All information sent to FinCEN in a SAR is treated as confidential information and not releasable to the public.
  - Implement "special measures" as required under the USA PATRIOT Act, Combatting Russian Money Laundering Act, and accompanying FinCEN regulations.[8]

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[7] *Id.* at 12130.

[8] Section 311 of the USA PATRIOT Act requires US financial institutions to implement certain "special measures" if the Secretary finds that reasonable grounds exist to conclude that a foreign jurisdiction, institution, class of transaction, or type of account is a "primary money laundering concern," which would require (i) recordkeeping and reporting certain transactions; (ii) collection of information relating to beneficial ownership; (iii) collection of information relating to certain payable-through accounts; (iv) collection of information relating to certain correspondent accounts; and (v)

- There is no CDD. In a joint rulemaking session that will occur no later than January 1, 2025, FinCEN and the SEC will issue new CDD requirements expected to cover RIAs and ERAs and require verifying the identity of the natural persons behind their corporate customers.[9] The proposed regulations would exempt RIAs and ERAs from having to identify natural persons as part of CDD, which is currently required by other financial institutions, until this new FinCEN/SEC joint rule is issued.[10]
- Mutual funds would not be subject to the proposed rule since they are already subject to BSA reporting requirements.[11]

How does the proposed rule impact compliance with the Corporate Transparency Act?

These new proposed rules will fill in certain reporting gaps of the Corporate Transparency Act (CTA).[12] For example, the CTA broadly exempts RIAs, venture capital advisers, and certain other pooled investment funds from any reporting requirements, including the requirement to submit SARs or beneficial ownership reports revealing natural person identities of limited partner investors. However, under these new proposed regulations, these firms will need to monitor the transactions of their limited partners and will be obligated to report any limited partners involved in money laundering or terrorist financing activities. The practical effect of the proposed regulations will be to require RIAs and ERAs to know most of the true identities of their investors' beneficial owners through the implementation of a risk-based AML/CFT program. We expect the upcoming proposed CDD rule in 2025 will likely require RIAs and ERAs to complete CDD on ***all*** customers (unless another financial institution already completed CDD).

What are the most common RIA and ERA concerns with the proposed rule?

All RIAs, venture capital advisers, and pooled investment funds exempt under the CTA will have a new regulatory burden. In addition, an ERA not exempt under the CTA with new CTA reporting obligations would also have to go further than it would under the CTA to identify and monitor all beneficial owners (as opposed to those with at least 25% in interest or control, which is the CTA

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prohibition or conditions on the opening or maintaining of correspondent or payable-through accounts. 31 U.S.C. § 5318A.

[9] 89 Fed. Reg. 12108, 12129 (February 15, 2024) (describing the CTA requirement to update the CDD rule).

[10] *Id.*

[11] *Id.* at 12108.

[12] Corporate Transparency Act, 31 U.S.C. § 5336.

requirement). There are a number of other complications that we foresee impacting RIAs and ERAs.

First, the rule applies to all currently existing funds, no matter if they were just established or are in their last year of activity. The initial cost to establish a program, train employees, and establish recordkeeping procedures is significant and, presumably, will require a review of all limited partner agreements to determine fee and cost allocations among the parties. Some limited partners may not want to comply with these new rules, which may raise significant fund governance issues in a large number of funds, which may impact RIAs and ERAs over a number of different fund categories.

Second, RIAs and ERAs will need to devote significant lead time and resources to establishing their compliance programs and processes. The type and location of an investor may impact the cost-benefit analysis of onboarding that investor. The more investors in a fund and the more funds that a firm manages, the more proactive they will need to be in gathering information, analyzing it with their legal and accounting advisors, and establishing a program to become compliant.

Third, once the program is up and running, any compliance program should routinely monitor transactions and investors and scale appropriately as new funds are established while maintaining the confidentiality of the information. Firms will need to institute recordkeeping processes for the five (5) years of transactions that must be archived under the BSA. All of these transactions will contain significant sensitive investor information, including accompanying market activities, that firms will have a duty to protect.

Fourth, there is no one-size-fits-all AML/CFT program. RIAs and ERAs should not look at this as a check-the-box compliance program. It will require active monitoring and compliance officers who will evolve the compliance program as money laundering techniques and structures change. The FinCEN proposed rule acknowledges that each firm will have different protocols and procedures based on their respective clientele. For example, firms that advise funds with significant foreign investment by individuals will have different procedures than firms that advise solely domestic institutional investors.[13] These AML/CFT compliance programs will likely be nuanced and highly fact dependent. However, the banking industry has tackled this problem for years, and good practices have been developed by AML compliance service providers.

Finally, FinCEN is seeking comment on a variety of other issues not covered above, such as whether sub-advisers should be exempt from compliance requirements, whether state-registered advisers should be required to comply with AML/CFT requirements, to what extent can an adviser rely on the AML/CFT program of another adviser or financial institution, and many other related scenarios.

[13] 89 Fed. Reg. 12108, 12109 (February 15, 2024) (discussing the risk-based approach).

What are standard RIA and ERA private fund limited partnership agreement (LPA) representations related to the CTA, and will these LPA representations need to be updated for this new FinCEN rule?

Below are standard LPA provisions related to the CTA we have seen used and there are others in the NVCA model forms that can be adapted. It is likely these provisions as well as general AML provisions will be updated to incorporate the new FinCEN rule, and such updates will be highly dependent on the content of the final rule. Many LPAs already have robust AML provisions due to other jurisdictions' requirements that may be leveraged here.

Corporate Transparency Act. The Members hereby acknowledge that, pursuant to the Corporate Transparency Act (31 USC 5336), and associated final rules established by the US Department of the Treasury's Financial Crimes Enforcement Network (collectively, the CTA Requirements), the Company may be required to make certain disclosures to the federal government regarding the direct or indirect ownership of the Company (referred to herein as a "beneficial ownership information report"). The Members further acknowledge that noncompliance with the CTA Requirements, including failure to timely file a completed beneficial ownership information report, could subject the Company to civil and/or criminal penalties. The Members hereby agree that they will cooperate with any request for information that is required to be included in a beneficial ownership information report or is otherwise required to maintain compliance with any CTA Requirements applicable to the Company.

The Managing Member shall comply and cause the Company to comply with the provisions of the Corporate Transparency Act adopted as Title LXIV (64) of the 2021 National Defense Authorization Act and the regulations promulgated thereunder, as each may be amended from time to time (collectively, the Corporate Transparency Laws). The Managing Member shall cause all required filings for the Company to be made within the time periods required under the Corporate Transparency Laws, including, without limitation, upon (i) formation of the Company, (ii) admission of any Members to the Company at Initial Closing, (iii) the transfer of any Interest of the Investor Member pursuant to Article IX hereof, and (iv) any transfer of any ownership interests within the Managing Member. The Investor Member, Special Investor Member, and Class B Investor Member shall promptly provide to the Managing Member any information with respect to the Investor Member, Special Investor Member, and Class B Investor Member, respectively, required to be included in the filings. The Managing Member shall indemnify and hold harmless the Company and the Investor Member, Special Investor Member, and Class B Investor Member against and from any and all claims, suits, actions, debts, damages, costs, charges, losses, obligations, judgments, and expenses of any nature whatsoever, including, but not limited to, any penalties and interest imposed by FinCEN and any attorney's and consultant's fees suffered or incurred by the Company or the Investor Member, Special Investor Member, and Class B Investor Member under or on account of or as a result of violations of the Corporate Transparency Laws, provided that

the Managing Member shall have no obligation to indemnify a Member to the extent such claim is the result of such Member's failure to provide accurate information for the Corporate Transparency Law filings within the time periods required under Corporate Transparency Laws.

Neither the General Partner nor the Partnership is a "reporting company" for purposes of the CTA, and the General Partner shall ensure the Partnership remains in compliance with the CTA at all times.

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