NAVIGANT

GLOBAL INVESTIGATIONS AND COMPLIANCE

ELLEN ZIMILES
Managing Director, Leader of the Financial Risk & Compliance Segment
Head of Global Investigations and Compliance
ellen.zimiles@navigant.com
+1.646.227.4612

ALMA ANGOTTI
Managing Director
alma.angotti@navigant.com
+1.202.481.8398

MICHAEL MENTER
Consultant
michael.menter@navigant.com
+1.646.227.4213

navigant.com/gic

About Navigant

Navigant Consulting, Inc. (NYSE: NCI) is a specialized, global professional services firm that helps clients take control of their future. Navigant's professionals apply deep industry knowledge, substantive technical expertise, and an enterprising approach to help clients build, manage and/or protect their business interests. With a focus on markets and clients facing transformational change and significant regulatory or legal pressures, the Firm primarily serves clients in the healthcare, energy and financial services industries. Across a range of advisory, consulting, outsourcing, and technology/analytics services, Navigant's practitioners bring sharp insight that pinpoints opportunities and delivers powerful results. More information about Navigant can be found at navigant.com.

THE FUTURE OF AML FOR INVESTMENT ADVISERS: THE FOURTH EU ANTI-MONEY LAUNDERING DIRECTIVE AND FINCEN'S PROPOSED RULES

I. INTRODUCTION

Regulators in the European Union ("EU") and the United States ("U.S.") are increasing Anti-Money Laundering requirements for investment advisers. On August 25, 2015, the Financial Crimes Enforcement Network ("FinCEN") proposed a rule requiring investment advisers registered with the U.S. Securities and Exchange Commission ("SEC") to establish anti-money laundering ("AML") programs and file suspicious activity reports ("SARs").[1] The proposed rule applies to both U.S. and non-U.S. investment advisers[2] and will authorize the SEC to conduct compliance examinations on registered investment advisers.[3] Estimates report that the proposed rules will affect over 11,000 investment advisers controlling over $62 trillion in assets.[4]

EU Member States are already expected to require investment firms to comply with the AML regulations applicable to all financial institutions. The EU's Fourth Directive on the Prevention of the Use of the Financial System for the Purpose of Money Laundering and Terrorist Financing ("Fourth Directive"), however, went into force on June 26, 2015, and adds customer due diligence, suspicious transactions reporting and other requirements which have significant implications for investment advisers.[5]

In this article, we discuss the future of AML for investment advisers with a comparison of FinCEN's proposed rule to the present EU regime's approach to investment advisers and a discussion of the changes both will bring for investment advisers.

II. EUROPEAN UNION REQUIREMENTS

The EU's Fourth Directive replaces the EU's Third Directive, which the EU enacted in 2005.[6] The EU Directives establish minimum requirements of each Member State's AML program to ensure continuity and prevent weak links in the EU's framework.[7]

1. 31 CFR Chapter X. RIN: 1506-AB10. See: https://www.fincen.gov/statutes_regs/frn/pdf/1506-AB10_FinCEN_IA_NPRM.pdf.
2. Id.
3. According to the U.S. Securities and Exchange Commission's Fiscal Year 2014 Agency Financial Report. See: http://www.sec.gov/about/secpar/secafr2014.pdf.
4. Id.
5. Directive (EU) 2015/849 of the European Parliament and of the Council, Official Journal of the European Union 5.6.2015 L 141/73
6. Directive (EU) 2005/60/EC of the European Parliament and of the Council, OJ 25.11.2005 L 309/15
7. Proposal for a Directive of the European Parliament and of the Council on the Prevention of the Use of the Financial System for the Purpose of Money Laundering and Terrorist Financing, Strasbourg, 5.2.2013 COM(2013) 45 Final 2013/0025 (COD), at pg 8.

A. Definition of Investment Firm

The Directives name "obliged entities" to which the AML programs must apply. Among those entities are financial institutions including investment firms,[8] which are defined as "any legal person whose regular occupation or business is the provision of one or more investment services to third parties and/or the performance of one or more investment activities on a professional basis."[9] The Third and Fourth Directives refer to the same document for this definition.[10]

B. New Requirements

The Fourth Directive adds new requirements regarding customer due diligence, suspicious transactions reporting, and records retention. A primary emphasis of these changes is the increased focus on a risk-based approach[11] applied at two levels: the national level and the entity level. On the national level, this approach provides flexibility to permit EU Member States to tailor measures as necessary to confront threats.[12] For the obliged entities, the approach requires them to "identify, understand, and mitigate their risks" and document their assessments. According to the 2013 proposal for the Fourth Directive, the two-level approach allows better allocation of resources based on evidence of risks.[13]

C. Minimum Requirements

The Fourth Directive sets forth minimum requirements Member States must apply regarding customer due diligence, including verification of the identity of customers and beneficial owners and ongoing monitoring of business relationships.[14] It tightens rules allowing for "simplified due diligence," which were determined to be too permissive under the previous regime.[15] In furtherance of the risk-based approach, Member States and obliged entities must consider a non-exhaustive list of factors, such as customer and transaction risk, in identifying areas of lower risk that may be appropriate for this relaxed standard.[16] The non-exhaustive list now includes geographical risk factors, such as whether a third country has an AML regime equivalent to the EU regime, that had been a separate category for permitting simplified due diligence.

D. Enhanced Due Diligence ("EDD")

The Fourth Directive also identifies areas of higher risk that require EDD. These include complex, unusual large transactions, unusual patterns of transactions, and transactions involving politically exposed persons ("PEPs").[17] The Fourth Directive includes a non-exhaustive list of factors indicating potential higher risk requiring EDD.[18] It also includes a broader definition of PEPs that now encompasses high-ranking members of international organizations in addition to foreign or domestic persons entrusted with prominent public positions.[19]

E. Financial Intelligence Unit ("FIU")

All Member States are required to establish an FIU, with which obliged entities must cooperate.[20] The Fourth Directive outlines the reporting of suspicious activity, but leaves specifics to the individual Member States. The Fourth Directive requires, however, that the obligated entities must report to the FIU on their own initiative[21] and refrain from disclosing the report to the customer.[22]

F. Record Retention and Data Protection

Under the Fourth Directive, Member States must require obliged entities to store due diligence files and records of transactions for five years and then delete that data,[23] reflecting the EU's consideration of privacy

8. OJ 25.11.2005 L 309/15 at Article 3(2).
9. Directive (EU) 2004/39 of the European Parliament and of the Council of 21 April 2004, OJ 30.4.2004 L 145/1, Article 4(1).
10. OJ 25.11.2005 L 309/15, Art. 3(2) and OJ 5.6.2015 L 141/73, Art. 3(2); citing OJ 30.4.2004 L 145/1, Article 4(1), supra
11. Strasbourg, 5.2.2013 COM(2013) 45 Final 2013/0025 (COD), at pg 9
12. Id. at pg 10.
13. Id.
14. OJ 5.6.2015 L 141/73, Art. 11.
15. Strasbourg, *supra*, at pg 10.
16. Id. at pg 11; list of factors provided at OJ 5.6.2015 L 141/73, Annex II.
17. OJ 5.6.2015 L 141/73, Art. 18.
18. Id.; list of factors provided at Annex III.
19. Id. at Art. 3(9). See also Strasbourg, *supra*, at pg 10.
20. OJ 5.6.2015 L 141/73 at Art. 32 and 33.
21. Id. at Art. 33(1)(a).
22. Id. at Art. 39.
23. Id. at Art. 40.

as a human right.[24] The data retention period may be extended by five years only "where the necessity and proportionality of such further retention has been established for the prevention, detection, investigation or prosecution of suspected money laundering or terrorist financing."[25]

The Fourth Directive further requires Member States to mandate internal procedures regarding data protection, sharing information, and training.[26] If a financial institution maintains branches and subsidiaries in third countries with insufficient AML regulations, the Fourth Directive requires the institution to apply the laws of its Member State.[27]

III. PROPOSED FINCEN REQUIREMENTS[28]

FinCEN's proposed rule would bring the Bank Secrecy Act ("BSA") in line with the European Union's categorization of investment advisors as "financial institutions."

A. Definition

FinCEN's definition of "investment advisor" is more specific than the EU definition of "investment firm," which encompasses nearly anyone providing investment services: "[a]ny person who is registered or required to register with the SEC under section 203 of the Investment Advisers Act of 1940."[29] (15 U.S.C. 80b-3(a))."

This definition excludes all but the largest investment advisers from the proposed rule. As FinCEN notes, large advisers with $100 million or more in regulatory assets under management generally are required to register with the SEC.[30] These advisers "would comprise the bulk of investment advisers that are included in the definition of investment adviser for purposes of the rules being proposed."[31] FinCEN indicates this definition is subject to expansion and may include other types of investment advisers, including state-regulated investment advisers or investment advisers exempt from SEC registration.[32]

B. AML Requirements

The proposed rule will subject covered investment advisers to most requirements applicable to all financial institutions, including the creation of an AML program and reporting and recordkeeping requirements.[33] FinCEN will not require a formal customer identification program ("CIP") through the proposed rule, but plans to address this via a joint rulemaking effort with the SEC.[34]

For more information on FinCEN's proposed rules for Investment Advisers, please refer to Navigant's previously published article: "FinCEN's Proposed Anti-Money Laundering Compliance For Investment Advisers: How to Prepare Now" (October 2015)."

IV. COMPARISON

Any comparison of FinCEN's proposed rule to the EU AML regime must be made with the understanding that the EU regime provides rules and guidance for legislation to be drafted by individual Member States. FinCEN, on the other hand, is the U.S. equivalent to the FIUs of the Member States.

The table below summarizes the difference between FinCEN's proposed rule and the EU regime.

There are two primary distinctions between the EU regime and the proposed FinCEN rule regarding investment advisers. First, the EU regime applies to every professional or firm engaged in investment services. The proposed FinCEN rule is not designed to apply so broadly. While FinCEN suggests the rule may expand, as drafted it primarily encompasses only the largest investment firms with $100 million or more in assets under management.

Second, FinCEN did not include a CIP requirement in the proposed rule, whereas EU investment advisers are subject to the same CIP rules as other EU financial institutions. Under both the existing FinCEN regime and the EU regime, financial institutions are subject to expansive due diligence rules, with the incumbent documentation and recording obligations. In light of the SEC's concurrent regulation of

24. See Council of Europe, European Convention for the Protection of Human Rights and Fundamental Freedoms, as amended by Protocols Nos. 11 and 14, 4 November 1950, ETS 5, Article 8.
25. OJ 5.6.2015 L 141/73 at Art. 40.
26. Id. at Art. 45(1.)
27. Id. at Art. 45(3.)
28. For more detailed analysis of FinCEN's proposed rule, see FinCEN's Proposed Anti-Money Laundering Compliance Requirements for Investment Advisers: How to Prepare Now. http://www.navigant.com/insights/library/gic/2015/fincen-aml/
29. 31 CFR Chapter X. RIN: 1506-AB10 (citing 15 U.S.C. 80b-3(a)."
30. Id.
31. Id.
32. Id.
33. Id.
34. Id.

	EU REGIME	PROPOSED FINCEN RULE
Application to investment advisers	Every professional or firm engaged in investment services	Only the largest investment firms with $100 million or more in assets under management.
CIP Rules	Investment advisers are subject to the same CIP rules as other EU financial institutions; expansive due diligence rules with incumbent documentation and recording obligations.	No CIP requirement, unlike other financial institutions. In light of the SEC's concurrent regulation of investment advisers, these two organizations will jointly draft rules addressing this area.
Risk-Based Approach	Yes	Yes
"Four Pillars" of AML Compliance	Yes	Yes
Prevents the sharing of certain financial data internationally, even among a firm's affliates.[35]	Yes	Yes

investment advisers, these two organizations will jointly draft rules addressing this area.

Beyond these distinctions, the EU regime should be familiar to financial institutions operating in the United States. Both apply a risk-based approach to AML allowing for firms of varying size to allocate resources to areas of greatest risk. The EU requires Member States to enact rules comparable to the "Four Pillars" of AML compliance required under the BSA: policies, procedures and internal controls; an AML compliance officer; ongoing training; and independent testing**.** It also requires similar rules regarding suspicious activity reporting and recordkeeping, as well as comparable requirements for sharing information with applicable government entities.

The two regimes also face similar difficulties that constrain their utilization and efficiency. For different institutional reasons, both the EU and FinCEN regulations prevent the sharing of certain financial data internationally, even among a firm's affiliates.[36] This may hinder the discovery of suspicious activity and limit the effectiveness of reporting requirements. It also presents challenges to compliance officers charged with creating and maintaining effective AML programs. This may be especially problematic for the large U.S. investment advisers contemplated by the proposed FinCEN rule and their contemporaries in Europe.

V. IMPLICATIONS FOR U.S. INVESTMENT FIRMS

Large U.S. investment firms will face significant changes in regulations under the proposed FinCEN rule, while firms with operations in both Europe and the U.S. should be well-prepared; practices used to meet the regulations of individual Member States will likely be transferable to the U.S. due to the similarity of the regimes. All firms should prepare to have due diligence programs to meet the forthcoming CIP regulations in the U.S.

To be prepared for the proposed FinCEN rule change, investment advisers should conduct a risk assessment, review current due diligence programs to identify the beneficial owners of all customers using risk-based identification, train staff to ensure the company is ready to implement AML compliance rules, and determine who will conduct independent testing. For further guidance on the necessary preparations, please refer to Navigant's previously published article: "FinCEN's Proposed Anti-Money Laundering Compliance For Investment Advisers: How to Prepare Now" (October 2015)."

35. Commission of the European Communities, Commission Staff Working Paper: Compliance with the Anti-Money Laundering Directive by Cross-Border Banking Groups at Group Level, Brussels, 30.6.2009, SEC(2009) 939 final; Evaluating the Security of the U.S. Financial Sector: Hearings before the House Financial Services Committee Task Force to Investigate Terrorism Financing, House, 114th Cong. (2015) (Testimony of Chip Poncy).
36. Commission of the European Communities, Commission Staff Working Paper: Compliance with the Anti-Money Laundering Directive by Cross-Border Banking Groups at Group Level, Brussels, 30.6.2009, SEC(2009) 939 final; Evaluating the Security of the U.S. Financial Sector: Hearings before the House Financial Services Committee Task Force to Investigate Terrorism Financing, House, 114th Cong. (2015) (Testimony of Chip Poncy).