



## FRA 7<sup>th</sup> Annual Investment Adviser Compliance Forum

# Anti-Money Laundering: Where Do Advisers Fit In?

**Mark E. Matthews,**  
*Morgan Lewis & Bockius*  
1111 Pennsylvania Avenue NW  
Washington, DC 20004  
202.739.5655  
[mark.matthews@morganlewis.com](mailto:mark.matthews@morganlewis.com)

**Beth D. Kiesewetter,**  
*Morgan Lewis & Bockius*  
1111 Pennsylvania Avenue NW  
Washington, DC 20004  
202.739.5127  
[bkiesewetter@morganlewis.com](mailto:bkiesewetter@morganlewis.com)

[www.morganlewis.com](http://www.morganlewis.com)

# Anti-Money Laundering – Where Do Advisers Fit In?

- **Current Federal Anti-Money Laundering Requirements For Investment Advisers**
  - OFAC Obligations
  - Currency and Monetary Instruments Reporting
  - Federal Statutes that Criminalize Money Laundering
- **Best Practices For Investment Adviser’s Anti-Money Laundering Programs**
  - Will Treasury Finalize The Proposed AML Program Rule for Investment Advisers?
  - Four Elements of the Proposed AML Program Rule
  - Considerations Relating to Voluntary Suspicious Activity Reporting
- **What Do Broker-Dealers, Mutual Funds, Insurance Companies and Hedge Funds Expect From Investment Advisers?**
  - Performing Customer Identification and Verification

# OFAC Obligations for Investment Advisers – *An Overview*

- **What is OFAC?**
- **Why Should Investment Advisors Care about OFAC?**
- **OFAC “*Lingo*” – What Does it all Mean?**
- **What Should an OFAC Compliance Program Include?**
  - *Risk Assessment*
  - *Internal Controls*
  - *OFAC Reporting*
  - *Independent Testing*
  - *Designated OFAC Compliance Officer*
  - *Ongoing Training*

# OFAC Obligations for Investment Advisers – *What is OFAC?*

- OFAC refers to the ***Office of Foreign Assets Control***, which is an office of the U.S. Department of Treasury
  - Administers and enforces economic and trade sanctions that further U.S. foreign policy and national security goals against:
    - ***Targeted Foreign Countries;***
    - ***Terrorists;***
    - ***International Drug Traffickers; and***
    - ***Persons Facilitating the Proliferation of Weapons of Mass Destruction.***
  - Acts pursuant to Presidential Wartime and National Emergency Powers and other Specific Legislation to:
    - ***Impose Controls on Transactions; and***
    - ***Freeze Assets under U.S. Jurisdiction.***

# OFAC Obligations for Investment Advisers – *Why Should Investment Advisors Care about OFAC?*

- All U.S. persons, including Advisors and their foreign offices and subsidiaries, must comply with OFAC’s regulations.
  - OFAC regulations generally require the:
    - **Blocking of accounts and property** of specified countries, entities and individuals; and/or
    - **Prohibition or rejection of unlicensed trade and financial transactions** with certain countries, entities and individuals.
  - Failure to comply with OFAC regulations can result in:
    - **Criminal penalties** ranging from \$50,000 to \$10 million and imprisonment from 10 to 30 years for willful violations; and/or
    - **Civil penalties** ranging from \$11,000 to \$1 million *per* violation.

# OFAC Obligations for Investment Advisers – *OFAC “Lingo” – What Does it all Mean?*

## – “SDN List”

- OFAC publishes a list called the “***Specially Designated Nationals and Blocked Persons***” that identifies individuals and companies owned or controlled by, or acting for or on behalf of, specific countries as well as individuals, groups and entities, such as terrorists and narcotics traffickers designated under programs that are not country-specific.
- Available at: <http://www.treas.gov/offices/enforcement/ofac/sdn>

## – “Prohibited Transaction”

- U.S. Persons are generally prohibited from engaging in trade or financial transactions and other dealings with any country, entity or individual identified on the SDN List and certain other countries, entities and individuals identified by other OFAC Sanctions Programs Lists.
- Available at: <http://www.treas.gov/offices/enforcement/ofac>

# OFAC Obligations for Investment Advisers – *OFAC “Lingo” – What Does it all Mean?*

## – “Blocked Transaction”

- Assets and accounts of countries, entities and individuals identified by the SDN List must be blocked (*i.e.*, **frozen**) when such property is located in the U.S., is held by U.S. individuals or entities, or comes into the possession or control of U.S. individuals or entities.
  - A blocked transaction results from the **receipt of assets and property**, or the establishment of an account for, a customer identified on the SDN List.
  - Such assets or account must be (i) **segregated** and (ii) **accrue interest at a commercially reasonable rate** until the customer is removed from the SDN List, the sanctions program is rescinded, or the customer obtains an OFAC license authorizing release of the property.

## – “Rejected Transaction”

- Where a transaction is prohibited by an OFAC trade or embargo program, but **no blockable assets or property** have been received in relation to the transaction, the transaction should simply be rejected (*i.e.*, **not processed**).

# OFAC Obligations for Investment Advisers – *What Should an OFAC Compliance Program Include?*

- **Risk Assessment:** The cornerstone of an OFAC Compliance Program is an assessment of risk presented by the Investment Adviser’s customer base, business activities or services and the location and nature of its transactions.
  - ***Higher Level OFAC Risk Indicators:***
    - International Funds Transfers
    - Nonresident Alien Accounts
    - Foreign Customer Accounts
    - Cross-Border Automated Clearing House (“ACH”) Transactions
    - Commercial Letters of Credit
    - Transactional Electronic Banking
    - Foreign Correspondent Accounts
    - Payable Through Accounts
    - International Private Banking
    - Overseas Offices or Subsidiaries
  - ***Depending Upon the Circumstances, Some OFAC Risk Indicators May be Weighed More Heavily Than Others***

# OFAC Obligations for Investment Advisers – *What Should an OFAC Compliance Program Include?*

- **Internal Controls:** An effective OFAC Compliance Program should include policies and procedures that are reasonably designed to **identify suspect accounts or transactions and report such information to OFAC:**
  - ***Identifying Accounts and Transactions For Review***
  - ***Updating OFAC Lists on Internal Interdiction Software Programs***
  - ***Screening ACH Transactions***
  - ***OFAC Reporting Process***
  - ***Maintaining License Information of Customers***

## OFAC Obligations for Investment Advisers – *What Should an OFAC Compliance Program Include?*

- **OFAC Reporting:** As previously highlighted, an OFAC Compliance Program should include policies and procedures for reporting validly blocked or rejected transactions.
  - *Immediate Reports:* Within *10 days* of valid OFAC hit resulting in blocked or rejected transaction.
  - *Annual Reports:* Total amounts blocked, including interest, must be reported to OFAC *by September 30* of each year (regarding information as of June 30).

# OFAC Obligations for Investment Advisers – *What Should an OFAC Compliance Program Include?*

- **Independent Testing:** A periodic independent review of the adequacy and effectiveness of the OFAC Compliance Program should be performed:
  - **Independent:** A person or group that is not directly responsible for the day-to-day operation of the OFAC Compliance Program.
    - **Internal Audit Department**
    - **Outside Auditors**
    - **Consultants**
    - **Law Firm**
  - **Frequency of Testing:** The frequency and scope of the independent testing review should be risk-based.
  - **Methodology for Testing:** Persons responsible for testing should follow established policies and procedures for determining the scope and nature of the testing conducted.

# OFAC Obligations for Investment Advisers – *What Should an OFAC Compliance Program Include?*

## – **Designated OFAC Compliance Officer:**

Responsibility for the day-to-day operation and overall implementation of the OFAC Compliance Program should be delegated to an OFAC Compliance Officer (or Committee) with:

- Ability to *enforce employee compliance* with the OFAC Compliance Program policies and procedures;
- *Sufficient knowledge and training* relating to OFAC regulations to implement such policies and procedures;
- *Responsibility for management of blocked accounts, assets and property*; and
- Authority to *determine when to report to OFAC* suspect accounts and transactions.

# OFAC Obligations for Investment Advisers – *What Should an OFAC Compliance Program Include?*

- **Ongoing Training Program:** Educating each employee about OFAC requirements provides the foundation for an effective OFAC Compliance Program.
  - ***Minimum Levels of Training Should be Mandatory***
    - High Level Overview Provided to All New Employees
  - ***Additional Training Tailored to Employee's Position***
    - Does the Employee's Position Involve Interaction With High Risk Indicators (e.g. international payments, foreign customers)?
  - ***Frequency of Training Should be Risk-Based***
    - More frequent training for persons responsible for ACH transaction processing or account opening
  - ***Documentation of Training Should be Maintained***
    - Copies of the Agenda and Materials Distributed
    - Copies of Attendance Lists

# Currency and Monetary Instrument Reporting – *What Must be Reported and to Whom?*

- Report of Cash Payments Over \$10,000 Received in a Trade or Business
  - IRS/FinCEN Form 8300
- Report of International Transportation of Currency and Monetary Instruments (“CMIR”)
  - FinCEN Form 105
- Report of Foreign Bank and Financial Accounts (“FBAR”)
  - Treasury Form TD F 90-22.1

## Federal Statutes that Criminalize Money Laundering – *Why Should Investment Advisers Care About Title 18 US Code?*

- Criminal Prosecution of Money Laundering is Tremendous Focus of US Government as well as International Governments
- The Tools and Techniques Developed to Detect / Prosecute the Laundering of the Proceeds of Drug Trafficking and Financial Crimes have been adapted for the War on Terrorist Financing
  - **CTRs, CMIRs, FBARs, SARs (Receive Significant Scrutiny)**
  - **International Focus (Swift Clearinghouse Controversy)**
- Treasury Department’s Terrorist Financing Program Received the Only “A” from 9/11 Commission
- Why do Prosecutors like to Charge Money Laundering?
  - **2005 Sentences:**
    - **Average for Fraud Convictions (17.2 months)**
    - **Average for Money Laundering Convictions (36.6 months)**
- Here the Risks are More Individually Focused / Less Institutional

# Federal Statutes that Criminalize Money Laundering – *Why Should Investment Advisers Care About Title 18 US Code?*

- **Title 18, US Code, Section 1956(a)(1)**
  - Four Elements of the Crime:
    - **Conduct, or Attempt to Conduct, a Financial Transaction**
    - **With the Proceeds of a “Specified Unlawful Activity”**
    - **Knowing, Suspecting or being “Willfully Blind” to the Fact that Funds were from Unlawful Activity**
    - **With an Objective to:**
      - *Promote a Specified Unlawful Activity*
      - *Evade US Taxes*
      - *Conceal or Disguise the Source Ownership / Nature of the Funds*
      - *Avoid Federal or State Transaction Reporting Requirements*
  - Penalties: Up to 20 Years Incarceration and/or Fine of the Larger of Twice Amount of Funds Involved or \$500,000

## Federal Statutes that Criminalize Money Laundering – *Why Should Investment Advisers Care About Title 18 US Code?*

- **Other Related Crimes:**
  - International Transactions (Sec. 1956(a)(2))
  - “*Sting*” Provision (Sec. 1956(a)(3))
  - Alternative Money Laundering Statute (Sec. 1957)

## Federal Statutes that Criminalize Money Laundering – *Why Should Investment Advisers Care About Title 18 US Code?*

- **Best Practices to Avoid Criminal Liability:**
  - Know your Customer
  - Know the Source of Funds
  - Engage in Transactions Appropriate to the Client and His or Her Financial Goals / Objectives
- **When in Doubt, Contact Your AML Compliance Officer**
  - The Best Protection for You and your Firm
- **AML Compliance Officer Strategies**
  - Communications with In-House Counsel / Outside Counsel
  - Assertion of Attorney-Client Privilege Over Performance of Due Diligence / Assessment
  - Reporting to Senior Management / Regulatory Authorities

# Best Practices For Investment Adviser's AML Programs - *Will The AML Program Rule Be Finalized?*

- **Proposed AML Program Rule for Investment Advisers Has *Not Yet* Been Adopted**
  - Will Treasury Finalize The Proposed AML Program Rule for Investment Advisers?
- **Statutory Basis for Proposed AML Program Rule:**
  - Section 352 of the USA PATRIOT Act requires the Treasury Department to coordinate with federal functional regulators to adopt implementing regulations requiring financial institutions to develop an AML Program
  - Once adopted, Investment Advisers would have *90 days within which to establish and implement an AML Program*
    - AML Program rule effective dates for other financial institutions have been extended to provide a *6 month* time frame before requiring implementation

# Best Practices For Investment Adviser's AML Programs - *What Should the AML Program Include?*

- **Four Elements of an AML Program**
  - ***Written AML Policies and Procedures***
    - Senior Management's AML Policy
    - Tailored to Risk Presented by Client Base, Nature of Business, Geographic Locations Where Operating
    - What about establishing a Customer Identification Program?
  - ***Designation of AML Compliance Officer***
    - Qualifications and Training
    - Authority to Enforce AML Program
  - ***Ongoing Employee Training***
    - Minimal Level of Training to All Employees
    - Specific Training for Employees Directly Involved in High Risk Areas
    - Document Training Provided (e.g., Agendas, Sign-In List)
  - ***Independent Testing***
    - Who is Sufficiently Independent to Test the AML Program?
    - Can Testing be Outsourced to a Service Provider?

# Best Practices For Investment Adviser's AML Programs - *Voluntary Suspicious Activity Reporting*

## – Considerations Relating to Suspicious Activity Reports

- The Proposed AML Program Rule for Investment Advisers Encourages *Voluntary SAR Filings*
- SAR Filing is Presently Required only for Financial Institutions with an AML Program Requirement, including:
  - *Banks,*
  - *Broker-Dealers,*
  - *Insurance Companies and*
  - *Mutual Funds*
- Safe Harbor from Liability for Reporting Suspicious Activity *Does Not Protect Investment Advisers,* Unless Acting as Agent for a Financial Institution with an AML Program Requirement

# What Do Broker-Dealers, Mutual Funds, Insurance Companies and Hedge Funds Expect From Investment Advisers? – *Customer Identification Programs*

- **Reliance on Investment Advisers’ CIP**
  - Where an Investment Adviser Has the Principal Customer Relationship, Financial Institutions Will Often Want to Outsource Performance of Customer Identification and Verification to the Investment Adviser
    - ***Some Financial Institutions May “Rely” on Investment Advisers Performance of CIP***
    - ***Some Financial Institutions May Only “Delegate” the Performance of CIP***
  - Customer Identification Programs are Presently Required only for Financial Institutions with an AML Program Requirement, including:
    - ***Banks,***
    - ***Broker-Dealers,***
    - ***Insurance Companies and***
    - ***Mutual Funds***

## What Do Broker-Dealers, Mutual Funds, Insurance Companies and Hedge Funds Expect From Investment Advisers? – *Customer Identification Programs*

- Because Investment Advisers Are Not Currently Subject to an AML Program Rule, They Are Not *Technically* Required to Implement a CIP Program
- What Should Be Included in a Customer Identification Program?
  - ***Policies and Procedures to Identify Clients and Verify the Clients' Identity***
    - Includes OFAC Checks Against SDN Lists
    - Must Include Enhanced Due Diligence Where Appropriate Based Upon Risk Assessment
  - ***Must Provide Financial Institution With “Reasonable Belief” that True Identity is Known***
  - ***Requires Financial Institution to Record Manner In Which Identity Was Verified***
    - May Be Documentary or Non-Documentary Methods

# What Do Broker-Dealers, Mutual Funds, Insurance Companies and Hedge Funds Expect From Investment Advisers? – *Customer Identification Programs*

- **Financial Institutions That May “Rely” on Investment Advisers Performance of CIP Obligations**
  - **Broker-Dealers**
    - SEC No-Action Letter to Securities Industry Association (Feb. 12, 2004) (*relief extended Feb. 10, 2005 and July 11, 2006*)
  - **Allows Broker-Dealers to “Rely” on Investment Advisers for Customer Identification and Verification if:**
    - ***Broker-Dealer Has Reasonable Basis for Reliance***
    - ***Investment Adviser Has Established an AML Program, Including a CIP***
    - ***Written Agreement Outlining Obligations of Each Party***
    - ***Broker-Dealer Obtains an Annual Certification from Investment Adviser that it has Performed AML Program, including CIP***
  - **Caution – “Reliance” is Liability Shifting**

# What Do Broker-Dealers, Mutual Funds, Insurance Companies and Hedge Funds Expect From Investment Advisers? – *Customer Identification Programs*

- **Financial Institutions May “Delegate” to Investment Advisers Performance of CIP Obligations**
  - **Mutual Funds and Insurance Companies (*Hedge Funds by Analogy*)**
    - Final CIP Rules Allow Financial Institutions to Delegate CIP Obligations to Non-Federal Functionally Regulated Financial Institutions
  - **Allows Delegation to Investment Advisers for Customer Identification and Verification if:**
    - *Financial Institution Has Reasonable Basis for Reliance*
    - *Investment Adviser Has Established an AML Program, Including a CIP*
    - *Written Agreement Outlining Obligations of Each Party*
    - *Financial Institution Obtains an Annual Certification regarding Performance of the AML Program, including CIP*
  - **Caution – “Delegation” involves Liability Sharing**



**FRA 7th Annual Investment Adviser  
Compliance Forum**

**Anti-Money Laundering:  
Where Do Advisers Fit In?**

**Mark E. Matthews,**  
*Morgan Lewis & Bockius*  
1111 Pennsylvania Avenue NW  
Washington, DC 20004  
202.739.5655  
[mark.matthews@morganlewis.com](mailto:mark.matthews@morganlewis.com)

**Beth D. Kiesewetter,**  
*Morgan Lewis & Bockius*  
1111 Pennsylvania Avenue NW  
Washington, DC 20004  
202.739.5127  
[bkiesewetter@morganlewis.com](mailto:bkiesewetter@morganlewis.com)

[www.morganlewis.com](http://www.morganlewis.com)