Advisers Face AML Pressure From SEC Despite Lack Of Regs

By Kyle Daddio and Michael Buffardi (February 3, 2020)

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On Jan. 7, the U.S. Securities and Exchange Commission's Office of Compliance Inspections and Examinations announced its 2020 examinations priorities.[1]

Two of OCIE's examination priorities — (1) anti-money laundering programs, and (2) increased examination coverage of registered investment advisers — are a shot across the bow for an industry already feeling increased AML compliance pressure before it formally has these regulatory obligations.

Recent enforcement actions, industry trends, and evolving products and services suggest this pressure will not be alleviated in the near future, regardless of the status of the final AML rules for registered investment advisers.

Status of Impending AML Obligations for Registered Investment Advisers

On Sept. 1, 2015, the Financial Crimes Enforcement Network published in the Federal Register a proposed a rule that would require SEC-registered investment advisers, and those required to be registered, to adopt AML programs. The proposed rule would also require investment advisers to file suspicious activity reports and currency transaction reports, as well as maintain certain records, which would bring investment advisers within the fold of the broader AML regulatory regime in the U.S.[2]

Investment advisers are not a statutorily defined financial institution for purposes of FinCEN's AML rulemaking authority.[3] However, based on operational and service similarities between investment advisers and other statutorily defined financial institutions (broker-dealers, banks, etc.), as well as money laundering risks presented by investment advisers, AML rules were nonetheless proposed by FinCEN under a catch-all provision.[4]

Meanwhile, other entities that are included in the statutory definition of "financial institution" remain exempted from such AML requirements. FinCEN proposing AML rules for investment advisers, before other statutorily defined financial institutions, strongly hints at the bureau's mindset in closing perceived gaps where there is AML risk.

On Feb. 3, 2017, the White House published in the Federal Register Executive Order 13771, which requires every executive department or agency to repeal two prior regulations for every new regulation it proposes.[5] As of the publication of EO 13771, FinCEN had yet to publish its final AML rule for investment advisers.

When trying to forecast the status of the investment adviser AML final rule, there are a few key considerations. FinCEN has significant reach with its regulatory regime, but it is a bureau widely known to have a lean catalog of regulations that fuels its broad influence. To that end, FinCEN may not have the excess regulations to repeal in order to implement investment adviser AML obligations.

However, there is an exemption in EO 13771 for regulations related to national security. In addition to its mission being firmly rooted in national security, FinCEN cites numerous times in its proposed rule the risks that money launderers, terrorist financiers, and other illicit actors present to registered investment advisers.

The clear national security implications increase the likelihood that a final rule would fit squarely within EO 13771's national security exemption, though it remains to be seen whether FinCEN takes that path.

As industry data continues to show an ongoing shift in the securities industry, with a decrease in broker-dealer registrations and an increase in investment adviser registrations, the delay in FinCEN's final AML rule for advisers is likely just that, merely a delay in the inevitable.[6]

While waiting for a resolution to the uncertainty regarding their own AML rules, investment advisers have found little cause to breathe easily. Instead, they have found SEC AML enforcement trends and evolving business relationships with executing broker-dealers creating a shadow regulatory environment where AML compliance is expected, even when it is not required.

Recent AML Enforcement Actions Involving Registered Investment Advisers

Recent enforcement actions by the SEC are a clear indication that independent investment advisers may find themselves increasingly subject to AML scrutiny by the SEC and their platforming broker-dealers.

Finding a cost-effective and end-user-friendly platform to execute trades and custody client securities is crucial for investment advisers in order to maintain a profitable compliant business. Numerous broker-dealers offer platforming services to investment advisers, including full-service cash management and securities capabilities and compliance monitoring software.

Investment advisers should be aware that the more comprehensive products and services offered by a platforming broker-dealer, the more their customers are integrated into that broker-dealer's AML program and suspicious activity report, or SAR, surveillance software, which may impose de facto AML requirements on investment advisers.

In 2018 alone, the SEC levied substantial AML penalties against Charles Schwab & Co. Inc. and TD Ameritrade Inc. solely for failing to file SARs on independent investment advisers and their customers who used the firms' advisory services platforms.[7]

The broker-dealers were penalized for failing to file SARs on activities that are fundamental to investment advisers' core business, including trading, money movements, fee calculations and even managing customer funds while making statements the SEC deemed to be materially misleading or false.[8]

Other late-2017 and 2018 SEC AML enforcement actions against Merrill Lynch and UBS Financial Services Inc. may have been broader in scope, but the message of the Charles Schwab and TD Ameritrade actions are clear — even if investment advisers are not required to monitor and report suspicious activity, the SEC will find a way to hold these advisers accountable for suspicious activity occurring through their executing broker-dealers.

Subsequent to the SEC's investment adviser-focused AML enforcement actions, investment

advisers may find themselves required to adopt a broker-dealer's internal policies and procedures in exchange for platforming services, even when those requirements go beyond current regulatory obligations.

At the very least, advisers may find themselves answering many more AML-related questions from their broker-dealer about their customers' money movements, trades, and how fees are calculated and paid.

For example, investment advisers may be accustomed to answering questions from regulators and broker-dealers about the trading strategies in accounts that have a high percentage of uninvested cash and few trades. While those inquiries were previously focused on identifying reverse-churning, the inquiries may now be focused on whether the advisers' customers are engaging in pass-through activity, a potential red flag for money laundering or other illicit financial crimes.

In light of the increased pressure by the SEC, investment advisers may be better served viewing customer relationships through an AML lens, even if not currently required, since the fallout of failing to do so may already be at their doorstep.

Hybrid Account Relationships at Affiliate and Dual Registrants

Investment firms registered with the SEC as both a broker-dealer and investment adviser, as well as affiliated broker-dealers and investment advisers that are registered under separate legal entities, provide a unique service to clients by being able to place them into accounts that best fit their needs.

In an emerging practice, customers are negotiating with dual or affiliate registrants to establish an account structure that combines elements of both an advisory and brokerage account. These hybrid accounts may be initially appealing but have hidden AML implications that could place affiliate or dual registrants in a precarious position with regulators and law enforcement.

A hybrid account may take various forms, but essentially is an account that is labeled an advisory account, but the customer pays a markup on trades on a transaction basis, rather than the customary advisory fee calculated by a percentage of assets under management.

This type of special account is usually requested by clients who are not active traders, but either (1) want the distinct fiduciary protection afforded investment adviser clients or (2) in the case of international clients, the customer may wish to use a separate, off-shore, qualified custodian to consolidate the location of their assets.

In exchange for these special circumstances, the customer may be willing to pay a greater markup fee than what is normally paid in the registrant's traditional brokerage arrangements.

To prevent commingling of transaction-based compensation within the investment adviser arm of the business, the markups on the hybrid account trades would be paid directly to the broker-dealer. The result of this arrangement can be a customer account being classified as an advisory account, which is not covered by most AML regulations, but functioning more like a brokerage account, which is covered.

Hybrid accounts appear to be a win-win for both the dual or affiliate registrants and their customer. That is, unless the customer also presents AML risk and its activities present red

flags that would ordinarily obligate a SAR filing by the broker-dealer.

If the dual or affiliate registrant decides that it will not file SARs on hybrid accounts because of their advisory designation, that does not mean the broker-dealer entity is actually alleviated of its SAR filing obligations.

Rather, the hybrid account customer relationship itself, and subsequent SAR decision, may increase the AML implications on the broker-dealer. These customers could be interpreted by regulators as engaging in forum shopping around current AML regulations.

Regulators could view this as a significant red flag for money laundering, especially when the customer is paying higher fees than other customers.

Additional concerns then may also be raised by regulators as to whether the broker-dealer entity was aware of these risks and facilitated the hybrid accounts in order to assist the customer in avoiding SARs, in exchange for higher account fees.

Hybrid accounts may provide benefits to both the customer and the affiliate or dual registrants. They may also represent significant AML liability for the parties involved, if it appears both the customer and registrants are using such a structure to evade SAR filing obligations in exchange for higher fees.

Affiliate and dual registrants should consider the optics of such an account relationship when viewed from the lens of future AML-related examinations or investigations.

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[1] U.S. Securities and Exchange Commission Office of Compliance Inspections and Examinations 2020 Examination Priorities (Jan. 7, 2020), available at https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2020.pdf.

[2] Department of the Treasury – Financial Crimes Enforcement Network, Anti-Money Laundering Program and Suspicious Activity Report Filing Requirements for Registered Investment Advisers, 80 FR 52680 (Sept. 1, 2015), available at https://www.govinfo.gov/content/pkg/FR-2015-09-01/pdf/2015-21318.pdf.

[3] See 31 U.S.C. § 5312.

[4] 80 FR 52680 at 52682-83.

[5] Executive Office of the President, Reducing Regulation and Controlling Regulatory Costs, 82 FR 9339 (Feb. 3, 2017), available at https://www.govinfo.gov/content/pkg/FR-2017-02-03/pdf/2017-02451.pdf.

[6] See generally FINRA, "A Report from the Financial Industry Regulatory Authority – 2019

FINRA Industry Snapshot" (2019), available at https://www.finra.org/sites/default/files/2019%20Industry%20Snapshot.pdf.

[7] In the matter of TD Ameritrade Inc., Admin. Proc. File No. 3-18829 (Sept. 24, 2018), available at https://www.sec.gov/litigation/admin/2018/34-84269.pdf and Securities and Exchange Commission v. Charles Schwab & Co. Inc., Civil Action No. 18-cv-3942 (U.S. District Court for the Northern District of California, July 2, 2018), available at https://www.sec.gov/litigation/complaints/2018/comp24189.pdf.

[8] See generally Id.