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Client Alert

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Request for Comments on FinCEN and SEC rule on CIP

The SEC and FinCEN Request Comments on their Proposed Rule on Customer Identification Programs for Registered Investment Advisers and Exempt Reporting Advisers

The Securities and Exchange Commission ("SEC") and the Financial Crimes Enforcement Network ("FinCEN") of the Department of Treasury issued a joint notice of proposed rulemaking (the "CIP Proposed Rule"), 89 Fed. Reg. 44571, requesting comments on the proposed requirement that certain investment advisers ("RIAs") and exempt reporting advisors ("ERAs"), such as hedge funds, private equity, and venture capital funds (collectively, "Covered Investment Advisors") implement customer identification programs ("CIPs").

The joint proposed rule follows FinCEN's notice of proposed rulemaking in February 2024 on anti-money laundering and countering the financing of terrorism ("AML/CFT") compliance program requirements and suspicious activity reporting ("SAR") filing obligations (the "AML/CFT Proposed Rule"). If adopted, the February 2024 AML/CFT Proposed Rule will include Covered Investment Advisers in the definition of "financial institution" under the Bank Secrecy Act ("BSA"), subjecting them to AML/CFT compliance program requirements and SAR filing obligations. *See* King & Spalding's alert here. If the joint SEC/FinCEN CIP Proposed Rule also is adopted, these same Covered Investment Advisers will be required to implement reasonable procedures to verify the identities of their customers and to develop and implement a CIP that complies with the proposed requirements on or before six months from the effective date of the regulation. Comments on this joint proposed rulemaking must be submitted by July 22, 2024.

BACKGROUND

The BSA is designed to combat money laundering, the financing of terrorism, and other illicit activity to safeguard the national security of the United States. The Director of FinCEN implements, administers, and

enforces the BSA. Under 31 U.S.C. § 5318(l), financial institutions must have minimum standards regarding the identity of their customers when opening an account, including, among other things, having reasonable procedures for verifying the customer's identity and recordkeeping.

By adding Covered Investment Advisers to the definition of "financial institutions" and subjecting them to the new CIP requirements, FinCEN and SEC aim to harmonize the CIP requirements with existing rules currently requiring brokers, mutual funds, credit unions, banks, and other financial institutions to adopt and implement CIPs. In light of this harmonization effort, most of the regulatory requirements, guidance by the regulators, and industry best practices developed over the past two decades will assist investment advisers in understanding their obligations with the new requirements, if they are adopted.

DEFINITIONS OF CUSTOMER AND INVESTMENT ADVISER

Customer. The proposed rule defines "customer" for the purposes of investment advisers' CIP obligations as a person, including a natural a person or a legal entity, who opens a new account with an investment adviser. Importantly, "account" is defined as "any contractual or other business relationship between a person and an investment adviser" for the performance of investment advisory services. Furthermore, the regulators are adopting a similar approach to CIP rules adopted previously for covered financial institutions by requiring that CIP procedures only apply to *new* customers, as long at the adviser continues to have a reasonable belief that it knows the true identity of the customer.

Investment Adviser. The proposed definition of "investment adviser" is the same in both the CIP Proposed Rule and the AML/CFT Proposed Rule, which covers advisers who are SEC-registered investment advisers or required to be so registered as well as exempt reporting advisers. Thus, the CIP Proposed Rule and AML/CFT Proposed Rule would apply to the same group of individuals or entities.

NEW CIP REQUIREMENTS

The CIP requirements under the CIP Proposed Rule, parallel the requirements applicable to other covered financial institutions subject to CIP requirements. All Covered Investment Advisers would be required to establish, document, and maintain a written CIP as part of their AML/CFT programs. This would include risk-based procedures for verifying the identity of customers, to the extent reasonable and practicable, and a requirement that such verification occur within a reasonable time before or after the customer's account is opened.

Notably, but not unexpected, the CIP Proposed Rule does not include provisions requiring Covered Investment Advisers to identify beneficial owners of legal entity customers, which other covered financial institutions are required to do under FinCEN's Customer Due Diligence ("CDD") Rule. As FinCEN noted in its February AML Program proposal, CDD revisions are under consideration in connection with the implementation of the Corporate Transparency Act. This will be an area to watch going forward to the extent that investment advisers become subject to AML/CIP requirements.

Minimum Information Required to be Gathered. The proposal requires that investment advisers obtain, at a minimum, certain identifying information *before* an account is opened. This information includes name, date of birth, a residential or business street address, and an identification number.

Verification Methods. The Identify verification procedures must enable the Covered Investment Adviser to form a reasonable belief that it knows the identity of each customer based on the assessment of the relevant risks presented by various types of accounts. Risk factors include various types of money laundering and terrorist financing activities present in their respective jurisdiction, whether the opening occurs in-person or online, types of services and transactions performed, or reliance on third-party firms. Verification may occur through documentary and non-documentary means or a combination of both. For example, the Proposing Release notes that, considering the recent increase in identity theft, a Covered Investment Adviser may supplement its verification of identification documents received from the customer with non-documentary means.

Covered Investment Advisers would also be required to have procedures for responding to circumstances in which the investment adviser cannot form a reasonable belief that it knows the true identity of a customer.

Recordkeeping. The Proposed CIP Rule imposes bifurcated recordkeeping requirements: identifying information must be retained for five years after the account is closed and verification records must be retained for five years from the date they are created.

Customer Notice. Financial institutions would need to give their customers adequate notice of their identity verification procedures.

Reliance on Another Financial Institution. Covered Investment Advisers may be able to reasonably rely on the performance by another financial institution of some or all the elements of the investment adviser's CIP, such as for identity verification procedures and certifications, provided that certain requirements are met.

REQUEST FOR COMMENTS

FinCEN and SEC invite comments on all aspects of the proposed regulations, including the definitions of account and customer, the need to re-verify a customer after a certain period of time, other existing regulatory obligations already in place for RIAs and ERAs, potential exemptions, reliance on financial institutions or service providers given that many Covered Investment Advisers already comply with such requirements in coordination with placement agents, fund administrators, prime brokers (*i.e.,* banks or brokers), and the proposed compliance date.

COSTS

As required, FinCEN and the SEC noted that they considered the costs associated with compliance with the CIT Proposed Rule.

Although creating or changing the policies and procedures detailed in the CIP would entail costs for registered investment advisers, they may already have certain procedures in place for obtaining identifying information of customers, including screening the SDN list or voluntary AML/CFT programs that are CIP-compliant and could serve as starting point. For example, SEC rules under the Investment Advisers Act of 1940 already require investment advisors to adopt and implement compliance programs that require written policies and procedures reasonably designed to prevent violation of the Advisers Act.[i] Costs also could be associated with temporarily losing or having diminished access to financial markets for those customers that may be unable to have their identities verified.

REASONABLE ALTERNATIVES

As required with rule proposals under the Regulatory Flexibility Act, FinCEN and the SEC have detailed certain reasonable alternatives to the proposed rulemaking, including whether investment advisers should be required to use the legal entity identifier ("LEI") based on the International Organization for Standardization ("ISO") or some other uniform

standard as the identifier by such customer. This could facilitate the automatic processing of financial transactions and assist Covered Investment Advisers and enforcement agencies in detecting money laundering more effectively due to uniformity and ease of analysis. FinCEN and SEC are also considering certain exceptions for customers that do not use investment advisers to access financial markets, such as those that only receive investment research services.

CONCLUSION

The CIP Proposed Rule aims to impose CIP obligations on Covered Investment Advisers that are required for other financial institutions. The new rule is intended to establish uniformity in AML obligations and close the gap in U.S. AML regulations, which has been called out by the Financial Action Task Force.[ii]

Most of the requirements are substantially similar to CIP requirements that have been in place for decades for other covered financial institutions, including broker-dealers, banks, and mutual funds. Thus, there is substantial guidance developed by FinCEN and the federal functional regulators, as well as industry and practitioner best practices that will be available to Covered Investment Advisers as the adapt their internal systems and training to comply with enhanced regulatory requirements, if adopted.

Finally, while many investment advisers, including those that are dual registrants or affiliates of covered financial institutions, may have already implemented CIP programs, it will be important to re-evaluate those procedures and processes in light of any final CIP rule adopted by FinCEN and the SEC.

King & Spalding is well positioned to provide clients with insights and guidance about the Proposed Rule.

[i] Final Rule - Compliance Programs of Investment Companies and Investment Advisers, U.S. Securities and Exchange Commission (Feb. 5, 2004), https://www.sec.gov/rules/2003/12/compliance-programs-investment-companies-and-investment-advisers

[ii] *See e.g* Financial Action Task Force Identifies Jurisdictions with Anti-Money Laundering, Combating the Financing of Terrorism, and Counter-Proliferation Deficiencies, Financial Crimes Enforcement Network (Feb. 29, 2024), https://www.fincen.gov/news/news-releases/financial-action-task-force-identifies-jurisdictions-anti-money-laundering