2024 Investment Adviser Risk Assessment

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Department of the Treasury

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1. EXECUTIVE SUMMARY[1]

The investment adviser (IA) industry in the United States consists of a wide range of business models that provide a variety of financial services to retail investors, high-net-worth individuals, private institutions, and governmental entities (including but not limited to local, state, and foreign government funds). The assets managed by investment advisers registered with the U.S. Securities and Exchange Commission (SEC) (known as registered investment advisers or RIAs), investment advisers exempt from SEC registration (exempt reporting advisers or ERAs), and state-registered investment advisers (who are generally prohibited from registering with the SEC) vastly exceed the holdings of U.S. banks.

Oversight of the investment adviser industry by federal and state securities regulators is broadly focused on protecting investors and the overall securities market from fraud and manipulation. Investment advisers are generally not subject to comprehensive anti-money-laundering and countering the financing of terrorism (AML/CFT) regulations and are not examined for AML/CFT compliance. Some investment advisers may perform certain AML/CFT functions if the entity is also a registered broker-dealer (*i.e.*, a dual registrant), is a bank, or is an operating subsidiary of a bank;[2] other investment advisers are affiliates of banks or broker-dealers, which may implement an enterprise-wide AML/CFT program that would include that investment adviser. Additionally, some investment advisers may perform certain AML/CFT functions through contractual obligations for a joint customer of another financial institution subject to the Bank Secrecy Act (BSA). But the practice is not uniform across the investment adviser sector and investment advisers' implementation of voluntary measures is not subject to comprehensive enforcement or examination. The absence of uniform AML/CFT requirements across all investment advisers also creates a circumstance where providers of the same financial services may be subject to different AML/CFT obligations (if any), and an investor or client seeking to obscure the origin of funds or its identity can choose an adviser that is not required to apply AML/CFT measures to its clients and activities.

A review of law enforcement cases, BSA reporting, and other information available to the U.S. government has identified several illicit finance threats involving investment advisers. First, IAs have served as an entry point into the U.S. market for illicit proceeds associated with foreign corruption, fraud, and tax evasion, as well as billions of dollars ultimately controlled by Russian oligarchs and their associates. IAs (including those that are exempt from SEC registration) and their advised funds, particularly venture capital funds, are also being used by foreign states, most notably the People's Republic of China (PRC) and Russia, to access certain technology and services with long-term national security implications through investments in early-stage companies. Finally, advisers (RIAs, ERAs, and state-registered advisers) have defrauded their clients and stolen their funds.

Investment advisers may be vulnerable to these threats for several reasons. First, the investment adviser sector is generally not required to implement comprehensive AML/CFT obligations, which creates arbitrage

1 This risk assessment has been coordinated with staff from relevant Treasury offices and bureaus, as well as staff from the Federal Bureau of Investigation (FBI), the Criminal Division of the Department of Justice, and the Securities and Exchange Commission (SEC). This risk assessment also builds on previous analysis of illicit finance risk in the investment adviser sector. *See, e.g.*, Treasury, *2022 National Money Laundering Risk Assessment*, pp. 63-66, https://home.treasury.gov/system/files/136/2022-National-Money-Laundering-Risk-Assessment.pdf.

2 Investment advisers that are banks (or bank subsidiaries) subject to the jurisdiction of the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (FRB), the Federal Deposit Insurance Corporation (FDIC), and the National Credit Union Administration (NCUA) (collectively, the Federal Banking Agencies, or FBAs) are accordingly also subject to applicable FBA regulations imposing AML/CFT requirements on banks. *See, e.g.*, 12 C.F.R. §§ 5.34(e)(3) and 5.38(e)(3) (OCC requirements governing operating subsidiaries of national banks and Federal savings associations).

opportunities for bad actors by allowing them to access the U.S. financial system through investment advisers with weaker or non-existent client due diligence. Second, in many cases, advisory business activities are segmented across intermediaries (and potentially national borders). This may create an information asymmetry: to the extent that AML/CFT obligations apply, the obliged entities (such as custodian banks or broker-dealers) working with an investment adviser may not necessarily have a direct relationship with the client (or, in the private fund context, underlying investor in the private fund) and may be unable to require an adviser to disclose relevant information.[3] At the same time, those entities that can obtain investor information (typically the adviser and certain service providers for the advised funds) are not required to do so or to report potentially suspicious activity. Third, certain business practices often promote the secrecy of client or investor identity and information, and the outsourcing of key compliance responsibilities.

This assessment finds that the highest illicit finance risk in the investment adviser sector is among ERAs (who advise private funds exempt from SEC registration), followed by RIAs who advise private funds, and then RIAs who are not dually registered as, or affiliated with, a broker-dealer (or is, or affiliated with, a bank). The private funds advised by RIAs, such as hedge and private equity funds, as well as venture capital funds, held approximately $20 trillion in assets under management (AUM) as of Q4 2022, and have limited reporting obligations under the federal securities laws. Investment advisers managing these funds also may routinely invest assets from foreign legal entities that are generally not required to disclose their ultimate beneficial owners. As of Q4 2022, private funds managed by RIAs represented $284 billion in equity beneficially owned by non-U.S. investors where the RIA did not know, and could not reasonably obtain information about, the non-U.S. beneficial ownership because the beneficial interest was held through a chain involving one or more third-party intermediaries.[4] Further, many of these funds are domiciled outside of the United States in jurisdictions with varying levels of AML/CFT regulation, and where Treasury assesses it is routine practice to rely on representations and warranties from intermediaries who represent investors when it is not possible to obtain investor-identity and source-of-funds information.[5]

3 However, as noted below, some RIAs have already implemented voluntary AML/CFT programs pursuant to the Securities Industry and Financial Markets Association (SIFMA) No-Action Letter under which the staff of the SEC's Division of Trading and Markets stated that it would not recommend enforcement action if a broker-dealer reasonably relies on RIAs to perform some or all aspects of the broker-dealer's customer identification program (CIP) obligations or the portion of customer due diligence (CDD) requirements imposing beneficial ownership identification and verification requirements for legal entity customers, provided that certain conditions are met. *See* SEC, Letter to Mr. Bernard V. Canepa, Associate General Counsel, Securities Industry and Financial Markets Association (SIFMA), Request for No-Action Relief Under Broker-Dealer Customer Identification Program Rule (31 C.F.R. § 1023.220) and Beneficial Ownership Requirements for Legal Entity Customers (31 C.F.R. § 1010.230) (Dec. 9, 2022), https://www.sec.gov/files/nal-sifma-120922.pdf (SIFMA No-Action Letter). This request for No-Action Relief was originally issued in 2004, has been periodically reissued, and remains effective.

4 *See* SEC, Private Fund Statistics, Fourth Calendar Quarter 2022 (2022 Q4 Private Fund Statistics), https://www.sec.gov/files/investment/private-funds-statistics-2022-q4.pdf. Question 16(m) on Form PF requires the reporting fund to identify the approximate percentage of the reporting fund's equity that is beneficially owned by different types of investors, including "Investors that are not United States persons and about which the foregoing beneficial ownership information is not known and cannot reasonably be obtained because the beneficial interest is held through a chain involving one or more third party intermediaries."

5 *See*, *e.g.*, Financial Action Task Force, *Concealment of Beneficial Ownership Information* (Jul. 2018), pp. 73-86, https://www.fatf-gafi.org/content/dam/fatf-gafi/reports/FATF-Egmont-Concealment-beneficial-ownership.pdf.

2. MARKET STRUCTURE AND REGULATORY FRAMEWORK

There are thousands of investment advisers in the United States with a wide range of business models geared towards providing advisory services to many different types of clients. Some of the advisory services that investment advisers provide include portfolio management, financial planning, and pension consulting. Advisory services can be provided on a "discretionary" or "non-discretionary" basis.[6] Investment advisers provide their expertise to a wide range of clients, including retail investors, high-net-worth individuals, private institutions, and governmental entities (including local, state, and foreign government funds).[7] Investment advisers often work closely with their clients to formulate and implement their clients' investment strategies. Investment advisers may be organized in a variety of legal forms, including corporations, sole proprietorships, partnerships, or limited liability companies.[8]

As of July 2023, there were 15,391 RIAs with approximately $125 trillion in AUM.[9] In addition, there were approximately 17,000 state-registered investment advisers across the United States,[10] and 5,846 ERAs, who are exempt from registering with the SEC, but must file certain information with the SEC.[11] RIAs and ERAs manage billions of dollars on behalf of individuals, institutional investors, or private funds, while state-registered investment advisers with smaller portfolios advise small businesses and individual investors.

Most investment advisers are generally subject to certain reporting requirements, but the scope of those requirements depends on whether the adviser is an RIA, registered at the state-level, or potentially exempt from registration as an ERA or otherwise not required to register with a federal or state securities regulator.[12] Registration requirements, in turn, generally hinge on the amount of an adviser's AUM and other factors, as explained below. RIAs are subject to various SEC rules and regulations governing, among other things, their marketing and disclosures to clients, best execution for client transactions, and disclosures of conflicts of interest and disciplinary information. ERAs must still file an abbreviated Form ADV with the SEC but are generally subject to fewer reporting and recordkeeping requirements than RIAs. Certain state-registered investment advisers may be subject to similar requirements under state securities laws and regulations.[13] Investment advisers, depending on their registration status, are also generally subject to examination by the SEC or state securities regulators.

6 An adviser has discretionary authority or manages assets on a discretionary basis if it has the authority to decide which securities to purchase and sell for the client. An adviser also has discretionary authority if it has the authority to decide which investment advisers to retain on behalf of the client. *See* Glossary to Form ADV, p. 28, https://www.sec.gov/about/forms/formadv-instructions.pdf.

7 *See* Part 1A, Item 5.D of Form ADV for a list of examples of different types of advisory clients.

8 *See* Part 1A, Item 3.A. of Form ADV.

9 The number of RIAs and corresponding AUM, and the number of ERAs, are based on a Treasury review of Form ADV information filed as of July 31, 2023. This Form ADV data is available at Frequently Requested FOIA Document: *Information About Registered Investment Advisers and Exempt Reporting Advisers*, http://www.sec.gov/foia/docs/invafoia.htm. The $125 trillion in AUM includes approximately $22 trillion in assets managed by mutual funds, which are advised by RIAs and are subject to AML/CFT obligations under the BSA and its implementing regulations. However, other parts of the sector, such as the $20 trillion managed for private funds, are not subject to comprehensive AML/CFT requirements (but still report some information on Form ADV).

10 North American Security Administrators Association, *NASAA Investment Adviser Section 2023 Annual Report,* p. 3 (NASAA 2023 Annual Report), https://www.nasaa.org/wp-content/uploads/2023/09/2023-IA-Section-Report-FINAL.pdf.

11 *Information About Registered Investment Advisers and Exempt Reporting Advisers*, http://www.sec.gov/foia/docs/invafoia.htm.

12 For instance, an investment adviser may be exempt from both *federal and certain state* requirements if it has less than $25 million AUM and fewer than six clients in a state. These advisers are not required to register, nor are they ERAs.

13 *See, e.g.,* Cal. Corp. Code, Ch. 3, §§ 25230-25238.

Unless an investment adviser is dually registered as a broker-dealer (*i.e.*, a dual registrant), is a bank (or a bank subsidiary), or otherwise affiliated with a bank or broker-dealer, an investment adviser generally does not implement AML/CFT program, reporting and recordkeeping measures.[14]

A. Investment Adviser Sector Participants

i) ***Investment Advisers***

An investment adviser, as defined by the Investment Advisers Act of 1940 (Advisers Act),[15] is a person or firm that, for compensation, is engaged in the business of providing advice to others or issuing reports or analyses regarding securities.[16] Designation as an investment adviser is a legal status that means that an individual or company has certain statutory obligations and is registered, or required to be registered, as an investment adviser with either the SEC or a state securities regulator, or is exempt from such requirements. Common names for investment advisers include, but are not limited to, asset managers, investment counselors, investment managers, portfolio managers, and wealth managers.[17]

Most investment advisers must submit a Form ADV, a self-disclosure form that collects certain information about the adviser.[18] Form ADV collects certain information about the adviser, including (depending on the adviser's registration status) its AUM, ownership, number of clients, number of employees, business practices, custodians of client funds, and affiliations, as well as certain disciplinary or material events of the adviser or its employees. ERAs who are not registered with the SEC or a state securities regulator are only required to file an abbreviated version of Form ADV—they are required to answer fewer client-related questions and provide less information about the services they provide. Form ADV does not require investment advisers to disclose the names of individual clients or investors.[19]

SEC-Registered Investment Advisers. Unless eligible to rely on an exemption, investment advisers that manage more than $110 million AUM must register with the SEC, as well as submit a Form ADV and update it at least annually.[20] The SEC administers and enforces the federal securities laws applicable to RIAs. As of July 31, 2023, there were 15,391 RIAs, reporting approximately $125 trillion in AUM for their clients.[21] RIAs employ individual investment adviser representatives (IARs). IARs generally must be licensed in the states where they work and are generally required to pass a credentialing exam before they can be licensed. According to the Investment Adviser Association, at the end of 2022, RIAs employed approximately 390,000 IARs.[22]

14 According to an analysis of Form ADV data, there were 436 RIAs dually registered as broker-dealers that managed approximately $10 trillion, and 20 RIAs that are banks that managed approximately $1.8 trillion. *See supra* n. 9. *See* Section B.1, *infra*, for additional information on IA implementation of AML/CFT measures.

15 *See* 15 U.S.C. § 80b-1 *et seq*.

16 *See* 15 U.S.C. § 80b-2(a)(11) for the definition of "investment adviser." Some persons and firms are statutorily excluded from the definition, including certain broker-dealers (§ 80b-2(a)(11)(C)), certain publishers (§ 80b-2(a)(11)(D)), and family offices (§ 80b-2(a)(11)(G)).

17 *See* Financial Industry Regulatory Authority (FINRA), *Investment Advisers*, https://www.finra.org/investors/learn-to-invest/choosing-investment-professional/investment-advisers.

18 Investment advisers register with the SEC by filing Form ADV and are required to file periodic updates. Form ADV is available at https://www.sec.gov/files/formadv.pdf. A detailed description of Form ADV's requirements is available at https://www.sec.gov/oiea/investor-alerts-bulletins/ib_formadv.html. An investment adviser may register with a state securities authority by filing Form ADV with that authority.

19 Advisers to private funds are, however, required to name their private fund clients on Section 7.B.(2) of Schedule D of Form ADV Part 1A. In some cases, those names may be coded.

20 *See* 17 C.F.R. §§ 275.203-1 & 204-1.

21 *See supra* n. 9.

22 *See* Investment Adviser Association, *Investment Adviser Industry Snapshot 2023*, pp. 19-20 (Investment Adviser Association Snapshot), https://investmentadviser.org/wp-content/uploads/2023/06/Snapshot2023_Final.pdf.

In recent years, almost all assets managed by RIAs (over 90% in 2022) have been held on a discretionary basis, meaning that the RIA decides which securities to purchase and sell for a client or which other investment advisers to retain on behalf of the client.[23] Further, in these cases, the RIA is the direct customer of the bank or broker-dealer that holds the RIA's client funds or securities. Approximately 3,800 RIAs[24] advise private funds, but do not qualify for an exemption from SEC registration (because, for example, they advise private funds with over $150 million in AUM in the United States or do not solely advise venture capital funds).

Exempt Reporting Advisers. An ERA is an investment adviser that would be required to register with the SEC but is statutorily exempt from such requirement[25] because: (1) it is an adviser solely to one or more venture capital funds; or (2) it is an adviser solely to one or more private funds and has less than $150 million AUM[26] in the United States.[27] Even though they are not required to register, ERAs must still file an abbreviated Form ADV with the SEC, and the SEC maintains authority to examine ERAs. As of July 31, 2023, there were 5,846 ERAs that were exempt from registering with the SEC but had filed an abbreviated Form ADV.[28]

- *Private Fund Advisers*. Private fund advisers, a type of ERA, are exempt from registering with the SEC if they exclusively advise private funds and have less than $150 million AUM in the United States. As of July 31, 2023, there were approximately 4,400 exempt private fund advisers, approximately 500 of which were also venture capital advisers.[29]
- *Venture Capital Advisers*. Venture capital advisers, another type of ERA, are exempt from registering with the SEC if they provide services only to venture capital funds,[30] regardless of the amount of AUM.[31] As of July 31, 2023, there were approximately 2,000 exempt venture capital advisers, approximately 500 of which were also private fund advisers.[32]

State-Registered Investment Advisers. State-registered investment advisers generally have less than $100 million in AUM. State-registered investment advisers are generally prohibited from registering with the SEC and instead register with and are supervised by the relevant state authority, unless they meet certain exceptions or their state does not supervise these entities.[33] State-registered investment advisers also file a Form ADV, which

23 *Id*. at p. 13.

24 *See* 2022 Q4 Private Fund Statistics, p.4, *supra* n. 4.

25 An adviser that is eligible to file reports as an ERA may nonetheless elect to register with the SEC as an RIA so long as it meets the criteria for registration. An investment adviser that relies on one of these exemptions must still evaluate the need for state registration.

26 Form ADV uses the term "regulatory assets under management" (RAUM) instead of "assets under management." Form ADV describes how advisers must calculate RAUM and states that in determining the amount of RAUM, an adviser should "include the securities portfolios for which [it] provide[s] continuous and regular supervisory or management services as of the date of filing" the form. *See* Form ADV, Instructions for Part 1A, Instruction 5.b.

27 *See* Sections 203(*l*) and 203(m) of the Advisers Act and 17 C.F.R. § 275.203(m)-1, respectively. ERAs are exempt from registration with the SEC, but are required to file reports on Form ADV with the SEC and are subject to certain rules under the Advisers Act.

28 The number of ERAs is derived from a Treasury review of Form ADV information filed as of July 31, 2023. *See supra* n. 9.

29 *Id*.

30 *See* 17 C.F.R. § 275.203(*l*)-1 (defining "venture capital fund").

31 Certain venture capital advisers may be registered with the SEC if they no longer satisfy the criteria to be ERAs (*e.g.*, they no longer pursue a venture capital strategy (by seeking to hold securities in companies past the initial public offering stage or pursuing hedge-fund like investment strategies)) or otherwise opt to register with the SEC.

32 Based on a Treasury review of Form ADV information filed as of July 31, 2023. *See supra* n. 9.

33 *See* 17 C.F.R. § 275.203A-2. Other exceptions to the prohibition on SEC registration include: (1) an adviser that would be required to register with 15 or more states (the multi-state exemption); (2) an adviser advising a registered investment company; (3) an adviser affiliated with an RIA; and (4) a pension consultant. Persons satisfying these criteria and the definition of "investment adviser" may register as such with the SEC. Investment advisers with a principal office and place of business in New York and over $25 million AUM are required to register with the SEC.

they submit to the relevant state regulator. State-registered investment advisers tend to be small, with 81 percent having one or two employees, and 99 percent having 10 or fewer employees.[34] As of December 31, 2022, there were 17,063 state-registered investment advisers who have approximately $420 billion in AUM.[35]

Foreign Private Adviser. A foreign private adviser is not required to register with the SEC if it: (1) has no place of business in the United States; (2) has, in total, fewer than 15 clients in the United States and investors in the United States in private funds advised by the adviser; (3) has aggregate assets under management attributable to these clients of less than $25 million; and (4) does not hold itself out generally to the public in the United States as an investment adviser.[36] Unlike ERAs, advisers specifically exempt under the foreign private adviser exemption are not subject to reporting or recordkeeping provisions under the Advisers Act, are not subject to examination, and do not make any filings with the SEC.

Family Offices. Family offices typically operate as advisory entities established by wealthy families to manage their wealth and provide related services to family members. Family offices are statutorily excluded from the definition of "investment adviser" under the Advisers Act.[37] Under SEC regulations, a "family office" is defined as a company that: (1) only has "family clients" (as defined in the rule, and referring generally to individuals related by a common ancestor); (2) is wholly owned by family clients and exclusively controlled by family members and/or family entities; and (3) and does not hold itself out to the public as an investment adviser.[38] This exemption does not apply to multi-family offices, which manage the wealth of two or more unrelated families.

Other exemptions from registration apply for investment advisers to insurance companies,[39] charitable organizations,[40] certain small business investment companies (SBICs),[41] certain rural business investment companies (RBICs),[42] and commodity trading advisors.[43]

Unregistered Investment Advisers. These include individuals or firms that should be registered with the SEC or an appropriate state securities regulator, but, potentially in violation of federal or state law, are not, or that have insufficient AUM and/or clients to be required to register with the states or the SEC.

ii) ***Investment Companies***

Generally, an investment company is a pooled investment vehicle (PIV) that issues its own securities and is primarily engaged in the business of investing in other securities. A PIV is an entity—often referred to as a fund—that an investment adviser or its affiliate creates to pool money from multiple investors. Investment companies vary significantly in terms of size, number and type of investors, holding periods,

34 *See* NASAA 2023 Annual Report at p. 5, *supra* n. 9.

35 *Id*. at p. 3.

36 *See* 15 U.S.C. §§ 80b-2(a)(30) and 80b-3(b)(3).

37 *See* 15 U.S.C. § 80b-2(a)(11)(G).

38 *See* 17 C.F.R. § 275.202(a)(11)(G)-1.

39 These advisers are exempt if their only clients are insurance companies. 15 U.S.C. § 80b-3(b)(2).

40 Charitable Organization Advisers are exempt if they (1) are registered as or work for a charitable organization and (2) provide investment advice only to charitable organizations, funds not defined as investment companies, trusts, or donative instruments, or trust beneficiaries. 15 U.S.C. § 80b-3(b)(4).

41 15 U.S.C. § 80b-3(b)(7).

42 15 U.S.C. § 80b-3(b)(8).

43 Commodity trading advisors are exempt if they are registered with the Commodity Futures Trading Commission (CFTC) as such and whose business does not consist primarily of acting as an investment adviser to investment companies or business development companies. 15 U.S.C. § 80b-3(b)(6)(A). A commodity trading advisor is also exempt if it is registered with the CFTC as such and advises a private fund. 15 U.S.C. § 80b-3(b)(6)(B).

and investment strategy.[44] An investment company is subject to the regulatory regime established by the Investment Company Act of 1940 (Company Act) and is required to register with the SEC, unless it qualifies for an exemption. There are four categories of investment companies:[45] open-end investment companies,[46] closed-end investment companies,[47] unit investment trusts (UITs),[48] and face amount certificate companies.[49] Many registered open-end investment companies (*e.g.*, mutual funds or exchange-traded funds) are subject to AML/CFT obligations under the BSA and its implementing regulations.[50]

However, not all companies that issue securities and are primarily engaged in the business of investing in securities are considered "investment companies" as defined in the Company Act. Some are excluded from the definition of "investment company," such as private funds, and are therefore not regulated as investment companies (or required to register as such) under the federal securities laws.

SEC-Registered Investment Companies. In addition to filing initial registration forms, registered investment companies must periodically file certain SEC and shareholder reports, meet minimum capital requirements, and file certain notices or pay fees to state regulators.[51] In addition, Section 13 of the Securities Exchange Act of 1934 (Exchange Act) requires investment managers who directly or indirectly manage discretionary accounts that hold certain publicly-traded equity securities to file reports if they own more than five percent of a voting class of an equity security (Schedules 13D and 13G),[52] as well as quarterly reports on certain investment holdings (Form 13F). According to the Investment Adviser

44 A few common types of funds include mutual funds, exchange-traded funds, hedge funds, private equity funds, and venture capital funds. *See* SEC Capital Raising Glossary, https://www.sec.gov/education/glossary/jargon-z#IC.

45 *See* 15 U.S.C. §§ 80a-4, 80a-5(a).

46 An open-end fund continuously pools funds and invests the money in various asset classes. Open-end funds can continuously offer shares to new investors. A registered open-end fund may be structured as a mutual fund, in which case its shares do not trade on a secondary market, or an exchange-traded fund, in which case the fund's shares will trade on a registered exchange. The shares are priced daily based on the net asset value (NAV) of the fund's holdings. Investors can sell their shares back to the fund (mutual fund) or into the market (exchange traded fund) if they want to redeem them.

47 A closed-end fund invests funds raised in its initial public offering in to invest in various asset classes. It does not continually offer new shares to investors, but a registered closed-end fund's shares can trade on a secondary market, such as the New York Stock Exchange or the NASDAQ Stock Market. The shares are priced continuously, and may trade at a premium or discount to their NAV. The closed-end fund is not required to buy back shares from investors seeking to redeem their shares.

48 A UIT invests the money raised from a one-time public offering in a generally fixed portfolio of stocks, bonds, or other securities. A UIT does not actively trade its investment portfolio but buys a relatively fixed portfolio of securities and holds them with little or no change for the life of the UIT. A UIT will terminate and dissolve on a date that is specified at the time the UIT is created.

49 Face-amount certificate companies are investment companies that are engaged or propose to engage in the business of issuing face-amount certificates of the installment type, or which have been engaged in such business and have any such certificates outstanding.

50 *See* 31 C.F.R. § 1010.100(gg) and 31 C.F.R. § 1024. As used in this risk assessment, "mutual fund" has the same definition as in FinCEN's regulations, and refers to an "investment company" (as the term is defined in Section 3 of the Investment Company Act (15 U.S.C. 80a–3)) that is an "open-end company" (as that term is defined in Section 5 of the Investment Company Act (15 U.S.C. 80a–5)) that is registered or is required to register with the SEC under Section 8 of the Investment Company Act (15 U.S.C. 80a–8). *See* 31 C.F.R. § 1010.100(gg). Exchange-traded funds (ETFs) are a type of exchange-traded investment product that must register with the SEC under the Investment Company Act and are generally organized as either an open-end company ("open-end fund") or unit investment trust. The SEC's ETF Rule (rule 6c-11 under the Investment Company Act), issued in 2019, clarified ETFs are issuing "redeemable securit[ies]" and are generally "regulated as open-end funds within the meaning of Section 5(a)(1) of the [Investment Company] Act." FinCEN's definition of a mutual fund under 1010.100(gg) applies to an ETF that is registered as an "open-end company" (as the term is defined in Section 5 of the Investment Company Act).

51 *See* SEC, *Investment Company Registration and Regulation Package*, https://www.sec.gov/investment/fast-answers/divisionsinvestmentinvcoreg121504htm.html#P52_4641.

52 *See* SEC, *Exchange Act Sections 13(d) and 13(g) and Regulation 13D-G Beneficial Ownership Reporting*, https://www.sec.gov/corpfin/divisionscorpfinguidancereg13d-interphtm.

Association, there were approximately 25,000 registered investment companies that held approximately $37 trillion in AUM as of 2022.[53]

Exemptions from SEC Registration. Section 3(c) of the Company Act excludes certain issuers from the definition of investment company. Many companies, including many hedge funds and private equity funds, rely on one of the exclusions from the definition of investment company set forth in Section 3(c)(1) and Section 3(c)(7) of the Company Act.[54] However, registered investment companies can pursue investment strategies similar to hedge and private equity funds, although with additional leverage and liquidity restrictions.[55]

- *Private Funds*. A private fund is defined as an issuer that would be an investment company, as defined in section 3 of the Company Act, but for section 3(c)(1) or 3(c)(7) of the Company Act.[56] Section 3(c)(1) provides an exclusion from the definition of "investment company" for any issuer whose outstanding securities (other than short-term paper) are beneficially owned by not more than 100 persons, or in the case of a qualifying venture capital fund 250 persons, and which is not making and does not presently propose to make a public offering of its securities. Section 3(c)(7) provides an exclusion from the definition of "investment company" for any issuer, the outstanding securities of which are owned exclusively by persons who, at the time of acquisition of such securities, are qualified purchasers, and which is not making and does not at the time propose to make a public offering.[57]
- According to the SEC, based on data from RIAs, as of Q4 2022, there were approximately 43,500 private funds holding approximately $20 trillion AUM and 3,800 advisers[58] advising these funds.[59] The SEC noted that between 2017 and 2022, there had been a 70 percent increase in AUM managed by advisers to private funds.[60] While the main office of 90 percent of these advisers to private funds are located in the United States, only 50 percent of the private funds that they advise are domiciled in the United States. Approximately 47 percent of such private funds are domiciled abroad (including Cayman Islands 32 percent, Ireland 5 percent, Luxembourg 4 percent).[61]

  U.S. investment advisers structure private funds in a variety of ways, taking into account many factors, including investor base and investment strategy. One possible structure may be the following: A U.S. investment adviser may sponsor offshore private funds to pool capital from multiple foreign investors, as well as certain tax-exempt U.S. investors. Offshore private funds may be feeder funds, used to pool these foreign, tax-exempt investments and move the combined value to another private fund, known as a master fund (generally by acquiring interests in the master fund). Offshore private funds may also serve as master funds. The master fund then further pools this capital with investments from taxable U.S. investors (either directly or indirectly through a U.S.-based feeder fund) and implements the investment strategy of the IA.

53 Investment Adviser Association Snapshot, pp. 32-33, *supra* n. 22.

54 *See* 15 U.S.C. § 80b-2(a)(29).

55 For example, Bridgewater Associates is an RIA that manages over $100 billion for large institutional investors and pursues multiple investment strategies.

56 *See supra* n. 54.

57 The term "qualified purchaser" is an investor that meets certain financial standards as defined in section 2(a)(51) of the Company Act (15 U.S.C. § 80a-2(a)(51)). For example, an individual may be a qualified purchaser if the investor owns $5 million or more in investments, and an entity may qualify if it owns and invests on a discretionary basis at least $25 million in investments.

58 These include only RIAs with at least $150 million in private fund AUM, and do not include RIAs with less than $150 million in private fund U.S. AUM, ERAs, or state-registered IAs. These advisers are not required to file Form PF, but report general information about the private funds they manage on Form ADV.

59 *See* 2022 Q4 Private Fund Statistics, *supra* n. 4.

60 *See* SEC 2022 Examination Priorities, p. 15, https://www.sec.gov/files/2022-exam-priorities.pdf.

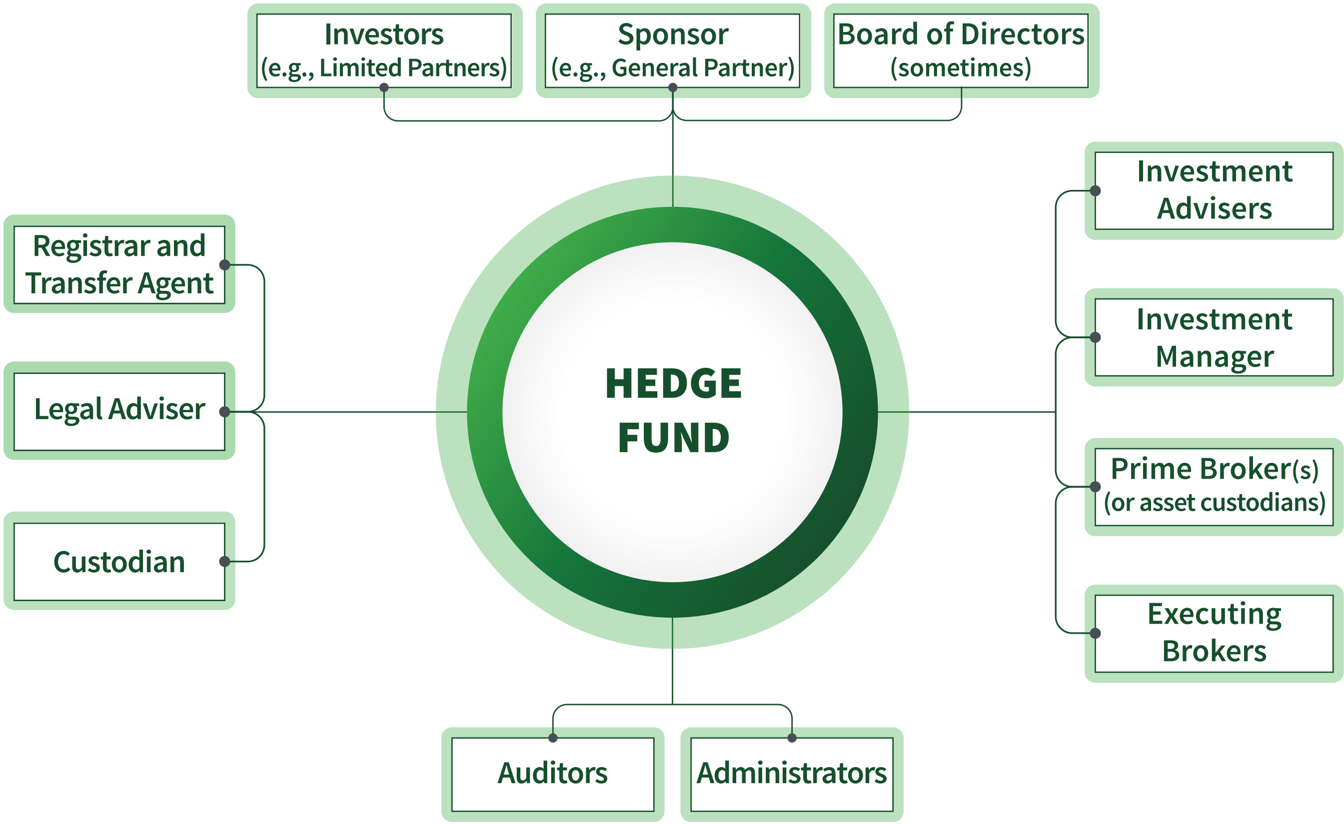
61 *See* 2022 Q4 Private Fund Statistics, *supra* n. 4.

While foreign persons may invest in U.S.-based funds directly, instead of through offshore funds, there is a disincentive to do so, as domestic funds may lead to U.S. tax consequences for investors.

Other exemptions to registration under the Company Act are provided for certain of the following:[62] government agencies and their instruments; issuers primarily doing business other than investing or trading in securities; excluded issuers such as brokers, charitable organizations, pension plans, and church plans; issuers located in U.S. possessions that primarily conduct business in those jurisdictions; RBICs;[63] and SBICs.[64]

Example: Hedge Fund Structure

A "hedge fund" is not a legal classification, but rather is a description of a private fund that pursues a certain investment strategy and is usually exempt from registration under the Company Act. Many hedge funds seek to profit by using leverage (*i.e.,* borrowing to increase investment exposure, which also increases risk), short-selling (which is an important service offered by prime brokers to hedge funds), and other speculative investment practices. Hedge funds typically charge both management fees (from 1 to 2 percent of AUM, payable to the investment adviser), and then performance fees (or incentive allocations), which are typically 20 percent of the profits and payable to the fund's sponsor (often an affiliate of the investment adviser). Below is an example of the relationships among the actual investment vehicle (the hedge fund) and its investors (or limited partners), sponsor (or general partner), investment adviser, custodian, prime broker, and other professional services providers.



62 *See generally* 15 U.S.C. § 80a-3(b), 3(c), and 6 for exemptions under the Company Act.

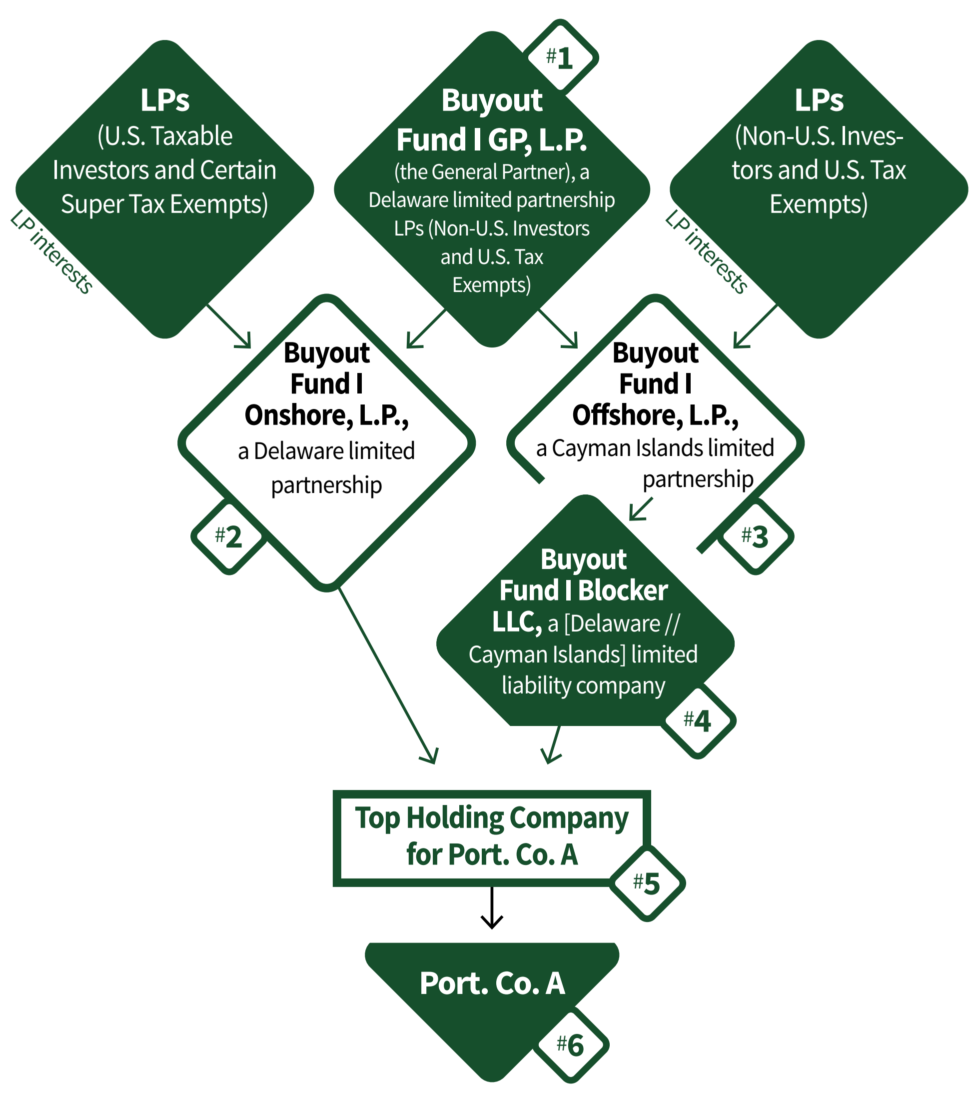
63 RBICs are licensed and regulated by the U.S. Department of Agriculture. They are privately-owned investment funds that invest in qualifying small businesses, primarily in rural areas.

64 SBICs are licensed and regulated by the Small Business Administration. They are privately-owned investment funds that invest in qualifying small businesses.

Example: Private Equity Fund Structure

A private equity fund is a type of private fund that is managed and advised by a private equity firm, which may be an investment adviser. Private equity funds pursue a variety of investment strategies (for example, buyout, growth equity) and do not offer investors redemption rights in the ordinary course. A typical investment strategy undertaken by a private equity fund is to take a controlling interest in a portfolio company and engage actively in the management and direction of the business to increase its value. Some private equity funds may specialize in making minority investments in fast-growing businesses or startups. Similar to hedge funds, private equity fund managers charge a management fee (one to two percent of committed or invested capital), and receive performance-based compensation. The performance-based compensation is generally approximately 20 percent of profits from investments, and it may be referred to as "carried interest" or an "incentive allocation."

- Buyout Management Company, L.P., the investment adviser, would enter into an investment management agreement with both funds (entities #2 and #3). The investment adviser is not pictured for simplicity.
- The investment management agreement authorizes the investment adviser to act on behalf of the funds, and it usually lays out the fees the funds will pay to the investment adviser.
- The investment adviser and the general partner (entity #1) act on behalf of the funds (entities #2 and #3) and serve as the nerve center for the fund structure.
- The day-to-day operations are typically carried out by the investment adviser. That entity is usually the employer and enters into various contracts, such as lease agreements for office space.



The chart above is an example that includes offshore investment and domestic investment funds. This is for illustrative purposes only as funds may be structured differently and it is not unique to private equity funds.

iii) ***Other Key Participants in Investment Advisory Activities***

Fund Administrators. These are third-party entities that provide valuation, administrative, and other services to a fund and its investors. These services include calculating fees, maintaining books and records, and handling subscriptions and redemptions.[65] Many fund administrators also conduct due diligence on potential investors and may implement AML/CFT requirements (where required by the fund's domestic law) or voluntary AML/CFT programs on behalf of the fund. Some large financial institutions have in-house fund administrators that service their own funds as well as well external funds; but other administrators are independent entities based outside of the United States (for instance, the Cayman Islands and Ireland are popular jurisdictions for fund administration activities).

Aggregators/Feeders. These are individuals or entities that help consolidate investments from high-net worth individuals or institutional investors, typically through a broker-dealer, for placement into a private fund that the investors may not be able to access on their own because they do not meet asset or income requirements to invest in private funds, do not otherwise have relationships with private fund advisers, or because they wish to avoid having to disclose their identities. Aggregators may be registered as investment advisers, broker-dealers, or other types of financial entities, or may be unregistered.

Prime Brokers. A prime broker is a bank or broker-dealer that offers services to large institutional clients, family offices, or hedge funds. These services include the execution of trades, settlement, financing, (including margin lending), access to research and management meetings, and custody.[66] An adviser can have more than one prime broker, and a fund is not obligated to route all of its business through the prime broker(s) that it has (*e.g.*, the fund may execute a purchase of shares "away" at another broker and then have the shares that it purchased through another broker be delivered to one of its prime brokers to hold those shares in custody).[67] Because prime brokers are banks or broker-dealers, they are subject to comprehensive AML/CFT obligations, either under the BSA and its implementing regulations, or in the case of prime brokers operating outside of the United States[68], similar foreign AML/CFT regimes, but the effective implementation of these AML/CFT regimes may vary by jurisdiction.

Qualified Custodians. As discussed further below, Rule 206(4)-2 (the Custody Rule) under the Advisers Act requires RIAs that have custody of client funds or securities generally to maintain those funds and securities with a "qualified custodian", defined primarily to encompass BSA-defined financial institutions.[69] Qualified custodians can be banks, registered broker-dealers, futures commission merchants, or certain

65 According to the Investment Adviser Association, as of 2022, 69 percent of private funds report using a third-party administrator (86 percent for hedge funds, 60 percent for private equity funds). Investment Adviser Association Snapshot, p. 68, *supra* n. 22.

66 The SEC has explained that an investment adviser has a duty with respect to "best execution" of a client's transactions where the adviser has the responsibility to select broker-dealers to execute client trades (typically in the case of discretionary accounts). *See Regulation Best Interest: The Broker-Dealer Standard of Conduct*, Final Rule, 84 Fed. Reg. 33318, 33412, (Jul. 12, 2019). In meeting this obligation, an adviser must seek to obtain the execution of transactions for each of its clients such that the client's total cost or proceeds in each transaction are the most favorable under the circumstances.

67 According to the Investment Adviser Association, only 13 percent of private funds use a prime broker. This is down from 24 percent in 2012, and due to the significant increase in the number of private equity funds, which do not need prime brokering services, as a share of private funds overall. Investment Adviser Association Snapshot, p.68, *supra* n. 22. *See also Interpretive Release Concerning the Scope of Section 28(e) of the Securities Exchange Act of 1934 and Related Matters,* Exchange Act Rel. No. 23170 (Apr. 28, 1986); *see also Commission Guidance Regarding Client Commission Practices under Section 28(e) of the Securities Exchange Act of 1934*, Exchange Act Rel. No. 54165 (Jul. 18, 2006).

68 *See NASDAQ*, *Glossary of Stock Market Terms*, https://www.nasdaq.com/glossary/p/prime-broker.

69 17 C.F.R. § 275.206(4)-2. The SEC recently proposed amendments to the Custody Rule. *See* SEC, *Safeguarding Advisory Client Assets*, Investment Advisers Act Release No. 6240 (Feb. 15, 2023), 88 Fed. Reg. 14672 (Mar. 9, 2023).

foreign entities. As of 2022, 94 percent of private funds use a qualified custodian.[70] Qualified custodians are generally subject to comprehensive AML/CFT obligations, either under the BSA and its implementing regulations or in the case of qualified custodians operating outside of the United States, similar foreign AML/CFT regimes[71], but the effective implementation of these AML/CFT regimes varies by jurisdiction.

General Partner (GP). A GP is an individual or an entity—typically affiliated with the fund's adviser—that raises money from limited partners (LPs) for a private fund organized as a limited partnership and that both invests in and manages the fund.[72] A fund that is organized using a different corporate structure, such as a limited liability company (LLC), has a managing member or other manager under applicable state law and governing documents of the fund instead of a general partner.

Limited Partner (LP). An LP is an investor who commits capital to a private fund.[73] Unlike a GP, an LP's participation in the fund's investment activities is restricted (*i.e.*, the LP generally lacks investment discretion with respect to how the fund uses the capital that it receives), and the LPs personal liability for fund debt is generally limited to the amount of money that the LP contributed or committed to contribute to the private fund. The relationship of an LP to the fund and the GP is governed by a limited partnership agreement. For a fund that is organized as an LLC, the investor is referred to as a "member" under applicable state law and the governing documents of the fund, and the investment adviser (or its affiliate) is typically referred to as the "manager" or "managing member."

B. Investment Adviser Regulatory Framework

Laws and Regulations. The Advisers Act forms, along with its implementing rules and regulations, the primary framework governing investment advisory activity (as well as certain aspects of other activities undertaken by investment advisers), along with other federal securities laws and their implementing rules and regulations, such as the Company Act, the Securities Act of 1933 (Securities Act) and the Exchange Act.[74] Since the Advisers Act was amended in 1996 and 2010, generally only investment advisers who have at least $100 million AUM or advise a registered investment company may register with the SEC.[75] Other investment advisers typically register with the state in which the investment adviser (IA) maintains its principal office and place of business. Some of the key Advisers Act implementing regulations relevant to this risk assessment are summarized below:

- *Custody Rule*. As discussed above, the Custody Rule,[76] which generally requires that client securities and funds over which an RIA has custody be held at a "qualified custodian" (which may be a financial institution that is subject to U.S. AML/CFT obligations but also can be a foreign financial institution subject to comparable AML/CFT obligations), is intended to protect advisory clients from loss, misuse, theft or misappropriation by, and the insolvency or financial reverses of, RIAs. The qualified custodian either maintains client funds and securities in a separate account for each client under that client's name, or in accounts that contain only client funds and securities under the name of the investment adviser as agent or trustee for clients.

70 *See* Investment Adviser Association Snapshot, p. 68, *supra* n. 22.

71 *See* 17 C.F.R. § 275.206(4)-2 (d)(6) (defining qualified custodian).

72 SEC, *Capital Raising Glossary*, https://www.sec.gov/education/glossary/jargon-z#GP.

73 *Id*., https://www.sec.gov/education/glossary/jargon-z#LP.

74 *See* SEC, Division of Investment Management, *Laws and Regulations*, https://www.sec.gov/investment/laws-and-rules.

75 Investment advisers with more than $100 million assets under management *may* register with the SEC, and investment advisers with more than $110 million in assets under management *must* register with the SEC, unless eligible for an exception. *See* 17 C.F.R. § 275.203A-1.

76 17 C.F.R.§ 275.206(4)-2. The SEC recently proposed amendments to the Custody Rule. *See supra* n. 69.

- *Compliance Rule*. Under the Compliance Rule, an RIA must adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and its implementing rules and regulations.[77] These policies and procedures should take into consideration the nature of that firm's operations and should be designed to prevent, detect, and promptly correct any violations promptly. The Compliance Rule also requires each RIA to review its policies and procedures no less frequently than annually to determine their adequacy and the effectiveness of their implementation. The review should consider any compliance matters that arose during the previous year, any changes in the business activities of the RIA or its affiliates, and any changes in the applicable laws or regulations. Finally, the Compliance Rule requires each RIA to designate a chief compliance officer to administer its compliance policies and procedures.
- *Books and Records Rule*. RIAs are required to make and keep certain books and records relating to their IA business.[78] These include:
    - financial and accounting records;
    - records that pertain to providing investment advice and transactions in client accounts with respect to such advice;
    - records that document the RIA's authority to conduct business in client accounts;
    - advertising and performance records;
    - records related to the Code of Ethics Rule;
    - records regarding the maintenance and delivery by the RIA of written disclosure documents and disclosure documents provided by certain solicitors who seek clients on the RIA's behalf; and
    - policies and procedures adopted and implemented under the Compliance Rule, including any documentation prepared in the course of the RIA's annual review.

    Some RIAs, such as those that custody client funds or provide supervisory or management services, are required to maintain additional records.

Reporting Requirements: Form ADV and Form PF. Generally, RIAs, state-registered investment advisers, and ERAs are required to file a Form ADV with the SEC, the relevant state authority, or both; the submissions are publicly available.[79] This form collects identifying information about the adviser, such as contact information; registration type and status; controlling persons, owners, and executive officers; and types of services offered. The questions about information related to clients include the total number of clients, percentage of clients that are non-U.S. persons, a count of each type of client (*e.g.*, high-net-worth individuals, charitable organizations, pension, and profit-sharing plans), the qualified custodians managing the underlying assets for each individual fund, and their corresponding amount of regulatory AUM. Additional supplements to Form ADV are required depending on the type of investment adviser (RIA vs. state-registered) and types of activities (*e.g.*, managing private funds). For instance, all RIAs who advise private funds and ERAs complete Section 7.B.(1) (Private Fund Reporting) of Schedule D of Form ADV for each private fund they advise, which collects certain information regarding the private fund and its service providers, including the name of the auditor, prime broker, custodian, and administrator. ERAs are required to answer fewer client-related questionsand are not required to provide as much information about the services they provide.

77 17 C.F.R.§ 275.206(4)-7.

78 17 C.F.R.§ 275.204-2.

79 *See* 17 C.F.R. §§ 275.203-1 & 204-4; *see also supra* n. 16.

While Form ADV requires investment advisers to answer general questions relating to clients, advisers are not required to disclose in Form ADV the names of individual clients (in many cases) or investors. According to the FBI, the lack of this information has presented challenges for law enforcement investigations, as law enforcement may have to obtain client identity information elsewhere, which often requires additional time and investigative resources.

RIAs that manage one or more private funds are also required to file Form PF,[80] but the information reported varies based on the size as well as classification of the private fund.[81] Form PF collects information about the percentage of the funds' equity that is beneficially owned by different types of clients such as broker-dealers, pension plans, individuals who are U.S. persons, and individuals who are non-U.S. persons (but not investor names). For non-U.S. persons, Form PF requires that the RIA identify the percentage of investor assets for which beneficial ownership information is not known and cannot reasonably be obtained because the beneficial interest is held through a chain involving one or more third-party intermediaries. As of Q4 2022, private fund advisers reporting on Form PF noted that the beneficial ownership of their private funds included $375 billion by non-U.S. individuals, and that they could not reasonably ascertain the beneficial owners for $284 billion AUM attributed to non-U.S. investors.[82]

Form PF must be submitted by any RIA that (1) manages one or more private funds, and (2) collectively (*e.g.*, with its affiliated entities) had at least $150 million in private fund AUM as of the last day of its most recently completed fiscal year.[83] Some private fund advisers that are required to report on Form ADV are not required to file Form PF (for example, ERAs, which includes advisers to venture capital funds as well as advisers with less than $150 million in private fund AUM).[84] Unlike Form ADV, Form PF is non-public; it is provided to both the SEC and the Financial Stability Oversight Council (FSOC) and is intended to enhance investor protection and provide the FSOC with data for use in assessing systemic risk.[85]

Fiduciary Obligation. An investment adviser's fiduciary duty to its clients under the Advisers Act applies to all persons or entities who meet the definition of "investment adviser" regardless of whether the adviser is registered.[86] The fiduciary duty comprises a duty of care and a duty of loyalty. The investment adviser must always serve the best interest of its client, which is a fund in the case of a fund adviser, and not subordinate its client's interest to its own. In other words, the adviser cannot place its own interests ahead of the interests of its client. This combination of care and loyalty been characterized as requiring the investment adviser to act in the "best interest" of its client at all times.[87] This includes a duty of undivided loyalty and utmost good faith, and the avoidance of conflicts of interests with their client, or full disclosure of the conflict. Investment advisers must employ reasonable care to avoid misleading clients and investment advisers have a fiduciary duty to provide full and fair disclosure of all material facts to clients

80 *See* 15 U.S.C. § 80b-4(b).

81 Reporting Form for Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisers. Form PF is available at https://www.sec.gov/files/formpf.pdf. For example, "large hedge fund advisers" and "large liquidity fund advisers" generally submit portions of Form PF quarterly, whereas other advisers generally submit portions of Form PF annually.

82 *See* 2022 Q4 Private Fund Statistics, *supra* n. 4.

83 *See* 17 C.F.R. § 275.204(b)-1.

84 *Id.*

85 *See* 15 U.S.C, § 80b-4(b)(7).

86 *See* SEC, *Commission Interpretation Regarding Standard of Conduct for Investment Advisers*, Investment Advisers Act Release No. 5248 (Jun. 5, 2019), 84 Fed. Reg. 33669 (Jul. 12, 2019).

87 *Id*.

and prospective clients, and to avoid misleading clients.[88] Generally, facts are “material” if a reasonable investor would consider them to be important. Departure from this fiduciary standard may constitute fraud upon clients.

Examination. RIAs are subject to examination by the SEC’s Division of Examinations. The SEC’s examination program is a risk-based program. An entity may be selected for examination for any number of reasons including, but not limited to, a statutory mandate that requires the Commission to examine the entity; the entity’s risk profile; a tip, complaint, or referral; or a review of a particular compliance risk area.[89] The scope of an examination will depend on the entity’s business model, associated risks, and the reason for conducting the examination. An examination typically includes a review of the entity’s operations, disclosures, conflicts of interest, and compliance practices with respect to certain core areas, including but not limited to, custody and safekeeping of client assets, valuation, portfolio management, fees and expenses, and brokerage and best execution. During an examination, the staff requests documents and information applicable to these core areas to gain an understanding of the entity’s conflicts of interest and its risks and corresponding controls, as well as to test the effectiveness of the entity’s compliance policies and procedures for monitoring, mitigating, and managing such risks and conflicts of interest.

Within the Division of Examinations, the Investment Adviser/Investment Company Examination Program completed more than 2,300 examinations of RIAs in FY22.[90] Examinations are confidential, and may result in one of three outcomes: (1) a finding of no further action, (2) a deficiency letter, and/or (3) a referral to the SEC’s Division of Enforcement, other regulators, or criminal authorities.

Enforcement. The SEC Division of Enforcement staff conducts investigations into possible violations of the federal securities laws, and litigates the SEC’s enforcement proceedings in the federal courts and in administrative courts.[91] In FY 2021, the SEC filed a total of 697 enforcement actions, of which 159, or 23 percent, were against RIAs or registered investment companies.[92] This reflects the Division’s focus on fraud and other misconduct by financial professionals in this space.[93]

88 *Id*.

89 *See generally* SEC, *Information for Entities Subject to Examination or Inspection by the Securities and Exchange Commission* (Mar. 2023), https://www.sec.gov/files/exam-brochure.pdf.

90 *See* SEC 2022 Examination Priorities, https://www.sec.gov/files/2022-exam-priorities.pdf.

91 *See* SEC, About the Division of Enforcement, https://www.sec.gov/enforce/Article/enforce-about.

92 SEC, Press Release, https://www.sec.gov/news/press-release/2021-238.

93 SEC, Addendum to Division of Enforcement Press Release Fiscal Year 2021, https://www.sec.gov/files/2021-238-addendum.pdf.

3. ILLICIT FINANCE RISKS

A. Threats

This risk assessment identifies four main categories of illicit finance activity involving the investment adviser sector in the United States. First, in some instances, the investment adviser industry has served as an entry point into the U.S. market for illicit proceeds associated with foreign corruption, fraud, and tax evasion. Second, certain advisers manage billions of dollars ultimately controlled by sanctioned entities including Russian oligarchs and their associates who help facilitate Russia's illegal and unprovoked war of aggression against Ukraine. Third, certain RIAs and ERAs and the private funds that they advise are also being used by foreign states, most notably the People's Republic of China (PRC) and Russia, to access certain technology and services with long-term national security implications through investments in early-stage companies. Fourth, certain investment advisers have stolen client assets, including through fraud.

To inform and support this risk assessment, Treasury conducted an analysis of available information, including select BSA reports filed between 2013 and 2021 that were associated with RIAs and ERAs.[94] That analysis found that 15.4 percent of RIAs and ERAs were associated with or referenced in at least one SAR (*i.e.*, they were identified either as a subject or in the narrative section of the SAR) during this time. Further, the number of SAR filings associated with RIAs or ERA increased by approximately 400 percent between 2013 and 2021—a disproportionately higher increase than the overall increase in SAR filings, which was approximately 140 percent.[95]

The most common activity types of suspicious activity identified in the investment adviser-related SARs were (in order of number of filings) (1) other suspicious activities, (2) securities/futures/options, (3) money laundering, and (4) fraud. In federal criminal cases involving an investment adviser as a defendant, the most common offense charged by the U.S. government was fraud. The remainder of this section contains descriptions of categories of threats as well as case studies and examples.[96]

i) ***Laundering of Illicit Proceeds Through Investment Advisers and Private Funds***

Private funds can be an attractive entry point for illicit proceeds because they present a possibility of higher returns on capital (as compared to other investment opportunities) in addition to anonymity. This is in contrast to other, more costly forms of money laundering, such as trade-based money laundering or informal value transfer systems. Like other types of pooled accounts or legal entities, they can be used to obscure the names of individual investors or beneficial owners so that the investment fund is identified as the owner of a particular asset. However, there are a wide variety of private funds, and some have characteristics that have traditionally been seen as less attractive to money launderers. For instance, some hedge funds may have lock-up periods of more than a year while venture capital funds and private equity funds generally do not permit any withdrawals of capital after initial investment in the fund and have longer lock-up periods due to the time it takes for the private companies in which those funds invest to go public or otherwise provide an exit strategy for these funds. While these restrictions may deter criminals who need immediate access to illicit proceeds, they are unlikely to deter illicit actors who seek stable returns, have a medium- to long-term investment horizon, and do not need immediate access to capital.

94 Information derived from an analysis of select BSA reporting.

95 From a FinCEN review of the total number of SARs filed between 2013 and 2021.

96 These examples demonstrate that investment advisers and the funds they advise have been implicated in certain financial crimes, and show the scope of potential benefit from imposing certain AML/CFT obligations on RIAs and ERAs.

In federal criminal cases involving money laundering charges reviewed in this assessment that involved an investment adviser, former adviser, or individual who held themselves out as an adviser, the most common predicate crimes charged were foreign corruption, fraud, and tax evasion. The mechanisms for laundering illicit proceeds through investment advisers and private funds vary, but generally consist of obscuring the illicit origins of funds and pooling them with legitimate funds to invest in U.S. securities, real estate, or other assets.

In some instances, the investment adviser or other financial professional may form a private fund through which illicit proceeds can be transferred as part of a money laundering scheme. While past examples have featured investment advisers complicit in illegal activity, an investment adviser may be unwittingly complicit in this type of activity if they are not required to understand the origin of funds or nature of their owner. A client wishing to launder money could ask an investment adviser to establish a private fund to certain specifications without informing the adviser of the client's broader scheme. Without AML/CFT requirements for investment advisers, the investment adviser might not have any obligation to evaluate potential money laundering or other illicit finance activity risks and could participate without inquiring further. In addition, without any reporting obligation for investment advisers, law enforcement would have to rely on information about investment advisers' clients as reported by banks, broker-dealers, and other financial institutions that do have reporting obligations but lack direct access to the underlying advisory client.

- In January 2021, the Department of Justice announced the settlement of a civil forfeiture action against assets of Sefira Capital LLC (Sefira) and 31 subsidiary corporations, which own high-end commercial and residential real estate throughout the United States.[97] According to the complaint, the defendant corporations allegedly accepted millions of dollars of narcotics proceeds laundered through the shadow financial system commonly known as the Black Market Peso Exchange (BMPE), for investment in various real estate ventures. Sefira is a Florida-based boutique investment company that has raised over $100 million in capital from various investors (Sefira Investors) to invest in real estate projects primarily in the Southeastern United States.[98] From 2016 to 2019, Sefira or its subsidiaries received millions of dollars in criminal proceeds from certain Sefira Investors as part of an effort by drug trafficking organizations and others to launder the criminal proceeds through the BMPE.
- In November 2019, Mark Scott, a former equity partner at the law firm Locke Lord LLP, was convicted of one count of conspiracy to commit money laundering and one count of conspiracy to commit bank fraud. According to the Department of Justice, beginning in 2016, Scott established fake private equity investment funds in the British Virgin Islands, known as the "Fenero Funds" to launder approximately $400 million in proceeds of a large international pyramid fraud scheme called OneCoin. Scott claimed that the investments were from "wealthy European families," when in fact the money represented proceeds of the OneCoin fraud scheme. Scott layered the money through Fenero Fund bank accounts in the Cayman Islands and the Republic of Ireland. As part of the scheme, Scott and his co-conspirators lied to banks, including U.S. banks, and other financial institutions, to cause those institutions to make transfers of OneCoin proceeds and evade AML procedures.[99] In January 2024, Scott was sentenced to 10 years in prison.[100]

97 Department of Justice, "Acting Manhattan U.S. Attorney Announces Settlement Of Civil Forfeiture Claims Against Over $50 Million Laundered Through Black Market Peso Exchange," (Jan. 12, 2021), https://www.justice.gov/usao-sdny/pr/acting-manhattan-us-attorney-announces-settlement-civil-forfeiture-claims-against-over.

98 *Id*.

99 Department of Justice, "Former Partner Of Locke Lord LLP Convicted In Manhattan Federal Court Of Conspiracy To Commit Money Laundering And Bank Fraud In Connection With Scheme To Launder $400 Million Of OneCoin Fraud Proceeds," (Nov. 21, 2019), https://www.justice.gov/usao-sdny/pr/former-partner-locke-lord-llp-convicted-manhattan-federal-court-conspiracy-commit-money.

100 Department of Justice, "Former Law Firm Partner Sentenced To 10 Years In Prison For Laundering $400 Million Of OneCoin Fraud Proceeds", (Jan. 25, 2024), https://www.justice.gov/usao-sdny/pr/former-law-firm-partner-sentenced-10-years-prison-laundering-400-million-onecoin-fraud.

- In October 2019, Frank Roberto Chatburn Ripalda (Chatburn), a dual U.S. and Ecuadorian citizen, pleaded guilty to one count of conspiracy to commit money laundering.[101] Chatburn worked at a financial advisory firm, Biscayne Capital, that had been registered with the SEC as an RIA.[102] The money laundering conspiracy was related to a scheme to pay bribes to officials of Ecuador's state-owned and state-controlled oil company, PetroEcuador. According to his admissions at the plea hearing, Chatburn conspired with an oil services contractor to pay nearly $3 million in bribes to Ecuadorian officials in an effort to obtain and retain contracts with PetroEcuador. As a financial advisor to the contractor, Chatburn agreed to make bribe payments for the benefit of several then-PetroEcuador officials through the use of shell companies and bank accounts in the United States, Panama, the Cayman Islands, Curacao, and Switzerland. To conceal the bribe payments and to promote the scheme, Chatburn established Panamanian shell companies with Swiss bank accounts on behalf of two then-PetroEcuador officials. Chatburn also admitted that he conspired with a third Ecuadorian government official to conceal bribe payments for the official from Odebrecht S.A., a Brazilian construction conglomerate. Chatburn facilitated hiding these bribe payments by conducting the transactions through several shell companies and bank accounts in multiple jurisdictions, including in the United States.[103]
- In July 2018, U.S. law enforcement arrested two alleged participants, Matthias Krull and Gustavo Adolfo Hernandez Frieri (Hernandez), in a billion-dollar international scheme to launder funds obtained through embezzlement, fraud, and bribery from Venezuelan state-owned oil company Petroleos De Venezuela S.A. (PDVSA).[104] According to the stipulated factual proffer filed in connection with his plea agreement, Hernandez conspired to launder approximately $12 million in PDVSA bribe proceeds by creating a private fund, domiciled in the Cayman Islands, and with a U.S. bank as custodian.[105] Specifically, he admitted that he conspired to launder $7 million in bribe payments related to a loan scheme, and $5 million in bribe payments related to a separate currency exchange scheme, through his investment advisory firm located in the United States. Separately, a co-conspirator in the scheme set up fraudulent bond schemes in which fake bonds would be issued, money transferred into the private fund, and then the bonds would "default."[106] In August 2018, Krull pleaded guilty to one count of conspiracy to commit money laundering, and in November 2019, Hernandez, a former investment adviser, also pleaded guilty to conspiracy to commit money laundering in connection with his role in the scheme.[107]

101 Department of Justice, "Miami-Based Financial Advisor Pleads Guilty for Conspiring to Launder Money Relating To FCPA and Ecuadorian Bribery Law Violations," (Oct. 11, 2019), https://www.justice.gov/opa/pr/miami-based-financial-advisor-pleads-guilty-conspiring-launder-money-relating-fcpa-and.

102 In 2016, Chatburn agreed to settle SEC charges by paying a $100,000 penalty, disgorgement of $78,924, and prejudgment interest of $8,052. Chatburn also was barred from working as an investment adviser or with an investment company with a right to reapply in four years and was ordered to cease and desist from committing or causing any future violations of the securities laws. *See* SEC, "SEC Charges Former Miami-based Investment Adviser and Its Principals With Failure to Disclose Multiple Conflicts of Interest to Clients," (May 27, 2016), https://www.sec.gov/files/litigation/admin/2016/ia-4399-s.pdf; *see also In Re Administrative Proceeding*, File No. 3-17263, In the Matter of Biscayne Capital International, LLC, Roberto G. Cortes, Ernesto H. Weisson, Juan Carlos Cortes, and Frank R. Chatburn, (May 27, 2016), https://www.sec.gov/litigation/admin/2016/ia-4399.pdf.

103 Department of Justice, "Miami-Based Financial Advisor Pleads Guilty for Conspiring to Launder Money Relating To FCPA and Ecuadorian Bribery Law Violations," https://www.justice.gov/opa/pr/miami-based-financial-advisor-pleads-guilty-conspiring-launder-money-relating-fcpa-and.

104 Department of Justice, "Former Swiss Bank Executive Pleads Guilty to Role in Billion-Dollar International Money Laundering Scheme Involving Funds Embezzled from Venezuelan State-Owned Oil Company," (Aug. 22, 2018), https://www.justice.gov/opa/pr/former-swiss-bank-executive-pleads-guilty-role-billion-dollar-international-money-laundering; Department of Justice, "Two Members of Billion-Dollar Venezuelan Money Laundering Scheme Arrested," (Jul. 25, 2018), https://www.justice.gov/opa/pr/two-members-billion-dollar-venezuelan-money-laundering-scheme-arrested.

105 Factual Proffer (Dkt. 164), *United States v. Hernandez,* No. 18-cr-20685 (S.D. Fl. Nov. 26, 2019), https://www.justice.gov/criminal-fraud/file/1316831/download.

106 Criminal Compl., *United States v. Guruceaga* (), 18-mj-3119 (S.D. Fl. Jul. 24, 2018), https://www.justice.gov/criminal-fraud/file/1119981/download.

107 Plea Agreement (Dkt. 163), *United States v. Hernandez,* (S.D. Fl. Nov. 26, 2019), https://www.justice.gov/criminal-fraud/file/1316826/download.

- In September 2016, a New York-based alternative investment and hedge fund manager, Och-Ziff Capital Management Group LLC and related entities, entered into resolutions to resolve civil and criminal charges and agreed to pay penalties to the Department of Justice and SEC of approximately $400 million in connection with a widespread scheme involving the bribery of officials in various countries, including the Democratic Republic of Congo (DRC) and Libya.[108] According to the companies' admissions to the Department of Justice, between 2005 and 2015, Och-Ziff, through its subsidiary OZ Africa Management GP LLC, paid millions of dollars in bribes to high level officials in the DRC to obtain preferential access to investment opportunities in the mining sector.[109] Additionally, from 2007 to 2010, Och-Ziff used a third-party to secure investments from the Libyan Investment Authority knowing that the agent would need to pay bribes in order to do so.[110] Och-Ziff's books and records also did not accurately describe the true purposes for which managed investor funds were used, and the company did not have adequate internal controls to detect or prevent the bribes.[111]
- In December 2012, investment funds affiliated with Low Taek Jho (Low) laundered approximately $150 million diverted from 1Malaysia Development Berhad's (1MDB) 2012 bond issuance into the U.S. financial system. Low was CEO of Jynwel Capital Limited, an investment adviser to a private equity fund in Asia.[112] Through a subsidiary of Jynwel Capital Limited, Low purchased equity interests in a vehicle managed by the Electrum Group, a private equity firm in the United States "whose offices are located in New York and Colorado, invests in public and private companies involved in the exploration and development of natural resources, precious metals, base metals, and oil and gas."[113] Electrum Group, LLC is registered with the SEC as an RIA. To conceal their origin, the funds were moved through multiple accounts owned by different entities on or about the same day in an unnecessarily complex manner with no apparent business purpose.[114]

108 Department of Justice, "Och-Ziff Capital Management Admits to Role in Africa Bribery Conspiracies and Agrees to Pay $213 Million Criminal Fine", (Sep. 29, 2016,) https://www.justice.gov/opa/pr/och-ziff-capital-management-admits-role-africa-bribery-conspiracies-and-agrees-pay-213; *see also* SEC, Press Release, "Och-Ziff Hedge Fund Settles FCPA Charges," (Sep. 29, 2016), https://www.sec.gov/news/press-release/2016-203. Unlike some of the other case examples in this section, this case does not involve the movement of illicit proceeds through an adviser, but instead details how an adviser can be involved in bribing public officials to access investment opportunities for other clients. It is being included to demonstrate how an adviser could be involved in illicit finance activity tied to its own investment decisions.

109 *United States v. Ochs-Ziff Capital Management Group, LLC* (Deferred Prosecution Agreement) p.29, (E.D.N.Y. Sep. 29, 2016), https://www.justice.gov/opa/file/899306/download.

110 *Id*.

111 SEC, Press Release, "Och-Ziff Hedge Fund Settles FCPA Charges," (Sep. 29, 2016), https://www.sec.gov/news/press-release/2016-203.

112 The U.S. government has secured guilty pleas or settlements in several cases tied to the 1MDB scheme. *See, e.g.*, Department of Justice, "Former Goldman Sachs Investment Banker Convicted in Massive Bribery and Money Laundering Scheme," (Apr.8, 2022), https://www.justice.gov/usao-edny/pr/former-goldman-sachs-investment-banker-convicted-massive-bribery-and-money-laundering. Low represented to counterparties and potential business partners that Jynwel Capital Limited was an investment adviser to a private equity fund.

113 Verified Compl. for Forfeiture (Dkt. 3) ¶ 760, *United States v. Real Property Located in London, United Kingdom Titled in the Name of Red Mountain Global Ltd.*, No. 19-cv-1326, (C.D. Cal. Feb. 22, 2019), https://www.justice.gov/opa/press-release/file/1134376/download.

114 *See id.* ¶ 204-12.

ii) ***Russian Political and Economic Elites' Access to U.S. Investments***

Investment advisers and the private funds they advise have served as an important entry point into the U.S. financial system for wealthy Russians seeking to obscure their ownership of U.S. assets.[115] Although many of these Russian individuals were not sanctioned by the U.S. government prior to Russia's full-scale invasion of Ukraine in February 2022, their wealth was sometimes associated with corruption, theft of state assets, or other illicit activity well before their designation.

A Treasury review of select BSA reporting filed between January 2019 and June 2023 identified more than 20 investment advisers located in the United States advising private funds where the adviser was identified as having significant ties to Russian oligarch investors or Russian-linked illicit activities. This review also identified 60 additional investment advisers located in the United States who managed private funds in which identified Russian oligarchs have invested, although there was no indication the adviser was engaged in any illicit activity.

According to information available to the U.S. government, often, a member of the Russian elite or their trusted proxy invests in a public or private U.S. company with the assistance of a wealth management firm, which is usually located in an offshore jurisdiction such as Bermuda, the Cayman Islands, or Cyprus, but services primarily Russian customers. The wealth management firm invests that money in dollars through the U.S. financial system, often into U.S. technology companies in fields including biotechnology and artificial intelligence. The scale of these investments is significant and may include billions of dollars invested for a single Russian oligarch. These investments are sometimes made directly by the foreign wealth management firm, and in other instances through a U.S.-based RIA or ERA.

In other instances, funds may be routed through a consulting firm or other entity acting as an investment adviser but not registered with or reporting to the SEC or a state regulator. For instance, on September 19, 2023, the SEC announced charges against Concord Management LLC (Concord) and its owner and principal, Michael Matlin, for operating as unregistered investment advisers to their only client—a wealthy former Russian official widely regarded as having political connections to the Russian Federation.[116] As of January 2022, Concord and Matlin allegedly managed investments for their sole client with an estimated total value of $7.2 billion in 112 different private funds.

iii) ***Foreign State Actors That Could Use Investment Funds to Access Critical Infrastructure or Sensitive Technologies***

Some strategic nation-state competitors to the United States, most notably the PRC, may see private funds as a back door to acquire assets of interest in the United States, such as equity stakes in companies developing critical or emerging technologies. While there are certain transactions for which notice must

115 *See* FinCEN Alert, FIN-2023-Alert002, *FinCEN Alert on Potential U.S. Commercial Real Estate Investments by Sanctioned Russian Elites, Oligarchs, and Their Proxies*, p. 4 (Jan. 25, 2023). In addition to Russian investors, investors tied to China and Saudi Arabia have invested in U.S. private funds. *See, e.g.*, The German Marshall Fund of the United States, *Policy Brief: An Effective American Regime to Counter Illicit Finance* (Dec. 2018), https://securingdemocracy.gmfus.org/wp-content/uploads/2018/12/An-Effective-American-Regime-to-Counter-Illicit-Finance.pdf.

116 In March 2022, the United Kingdom and the European Union sanctioned Matlin and Concord's client and the client's assets were subsequently frozen. The SEC's complaint alleges that, a month prior, in February 2022, Concord and Matlin assisted the client in his attempts to redeem investments and/or sell his securities portfolio. *See* SEC, Press Release 2023-186, SEC Charges New York Firm Concord Management and Owner with Acting as Unregistered Investment Advisers to Billionaire Former Russian Official (Sep. 19, 2023), https://www.sec.gov/news/press-release/2023-186.

be provided to the interagency Committee on Foreign Investment in the United States (CFIUS)[117], most transactions reviewed by CFIUS are filed voluntarily.[118] Where transactions are not voluntarily submitted to CFIUS for review, CFIUS agencies actively work to identify those transactions, including whether such transactions may be a covered transaction under the CFIUS regulations and may raise national security considerations, and assess whether to request that the parties file with CFIUS.[119]

Foreign state-funded investment vehicles may seek to hide their involvement in foreign investments through offshore legal entities and intermediaries in an effort to gain access to sensitive technology, processes, or knowledge that can enhance their domestic development of microelectronics, artificial intelligence, biotechnology and biomanufacturing, quantum computing, and advanced clean energy, among others. These state-funded investment vehicles could persuade an investment adviser to a private fund to grant them access to granular details about the technology or processes used by a company in which the fund is invested, including information that a limited partner investor seeking only an economic return may not typically request. Investment advisers are currently not required to report such suspicious activity.

PRC. According to the FBI, the PRC government routinely conceals its ownership or control of investment funds to disguise efforts to steal technology or knowledge and avoid notice to CFIUS.[120] According to a report by the Office of the U.S. Trade Representative, state-guided PRC venture capital fund activity in the United States is motivated by the PRC's Made in China 2025 plan and its military-civil fusion strategy, directing investments towards developing technology with dual-use capabilities.[121] In 2016, the PRC government explicitly endorsed the use of overseas venture capital funds to invest in "seed-based and start-up technology," demonstrating the link between the funds and government priorities.[122]

Russia. According to information available to the U.S. government, Russian elites and government entities are moving hundreds of millions of dollars annually through the U.S. financial system by using U.S. and foreign venture capital firms to invest in U.S. technology companies.

- A Treasury review of select BSA reporting identified several U.S. venture capital firms with significant ties to Russian oligarch investors that invested in firms developing emerging technologies with national security applications. These include autonomous vehicle technology and artificial intelligence systems, as well as contractors to the U.S. military, intelligence, and other government agencies.
- Further, according to information available to the U.S. government, the U.S.-designated, state-owned Russian Venture Company, which is funded by the U.S.-designated Russian Direct Investment Fund, endows

117 CFIUS is an interagency committee authorized to review certain transactions involving foreign investment in the United States to determine the effect of such transactions on the national security of the United States.

118 *See* Treasury, "Remarks by Assistant Secretary for Investment Security Paul Rosen at the Second Annual CFIUS Conference," (Sept. 14, 2023), https://home.treasury.gov/news/press-releases/jy1732.

119 *Id.*

120 *See* Hearing Before the U.S.-China Economic and Security Review Commission, p. 139, "Chinese Investments in the United States: Impacts and Issues for Policymakers," (Jan. 26, 2017), https://www.uscc.gov/sites/default/files/transcripts/Chinese%20Investment%20in%20the%20United%20States%20Transcript.pdf; *see also* Remarks by FBI Director Christopher Wray, "Countering Threats Posed by the Chinese Government Inside the U.S.," (Jan. 31, 2022), https://www.fbi.gov/news/speeches/countering-threats-posed-by-the-chinese-government-inside-the-us-wray-013122.

121 Office of the United States Trade Representative, "Findings of the Investigation into China's Acts, Policies, and Practices Related to Technology Transfer, Intellectual Property, and Innovation under Section 301 of the Trade Act of 1974," p. 14, (Mar. 22, 2018), https://ustr.gov/sites/default/files/Section%20301%20FINAL.PDF.

122 PRC State Council, "National 13th Five-Year Plan for the Development of Strategic Emerging Industries," (Nov. 29, 2016), https://cset.georgetown.edu/publication/national-13th-five-year-plan-for-the-development-of-strategic-emerging-industries/#:~:text=During%20the%2013th%20Five%2DYear,healthy%20economic%20and%20social%20development.

Russian seed funds to invest in emerging technology. The seed funds create a venture capital company, often of a similar name to the seed fund and registered outside of Russia, to invest in U.S. technology firms.

- The U.S. government has also identified instances where the leadership of certain investment firms has attempted to remove overt ties to Russia or Russian names. Russian investors have obfuscated their connections to Russia, including by relocating to other jurisdictions and changing their names, to continue investing in U.S. technology companies through venture capital vehicles.

iv) ***Investment Advisers Defrauding Their Clients***

The most common form of illicit activity involving investment advisers identified in the scope of this assessment involves IAs defrauding their clients. Unscrupulous individuals often use their real or perceived status as a legitimate IA to attract clients with promises of high returns and then steal their money, often following a Ponzi or Ponzi-like scheme.[123] In most of the identified cases, authorities pursued civil or criminal enforcement for violations of the federal securities laws against the IA or other associated individuals. While they do not involve the laundering of illicit proceeds by IAs, they are being included consistent with the methodology described at Annex 1.

- In December 2021, the founder of a New York financial advisory and investment company that had been registered with the SEC as an investment adviser was charged with wire fraud, investment adviser fraud, and money laundering in connection with a scheme to misappropriate more than $1 million from current and prospective clients. As alleged in the indictment, the individual, who has been an IAR, executed a calculated scheme in which he repeatedly lied to his current and prospective clients about putting their money into legitimate investments, when, in reality, he stole their money to fund his lavish lifestyle. As noted in the indictment, the victims sent multiple wire transfers to the private bank account of the advisory firm, and the individual then misappropriated the funds into his own personal banking account, among other things.[124]
- In October 2021, the SEC charged a former New Jersey broker-dealer representative and IAR with stealing nearly $3 million from his advisory clients and brokerage customers, which he used to buy gold coins and other precious metals and funneled to family credit card accounts that he controlled. Specifically, the complaint alleges that from January 2016 to January 2021, the individual, who worked at a dual registrant, transferred funds from his clients' and customers' accounts to pay off balances in credit card accounts held in the names of his wife and parents. The individual also allegedly caused checks to be fraudulently drawn on his clients' and customers' accounts. The complaint alleges that the individual made at least 137 fraudulent transactions and used the stolen funds to purchase gold coins and other precious metals, buy luxury goods, and make electronic fund transfers to himself. [125]

123 A Ponzi scheme is an investment fraud that pays existing investors with funds collected from new investors. *See* SEC, "Ponzi Scheme", https://www.investor.gov/protect-your-investments/fraud/types-fraud/ponzi-scheme.

124 Department of Justice, "Founder of Investment Advisory Firm Charged with Wire Fraud, Investment Adviser Fraud and Money Laundering," (Dec. 6, 2021), https://www.justice.gov/usao-edny/pr/founder-investment-advisory-firm-charged-wire-fraud-investment-adviser-fraud-and-money; *United States v. Slothower* (Indictment) Case 2:21-cr-00602 (E.D.N.Y Dec. 21, 2021). The SEC also filed charges against the RIA and its founder for misappropriating funds from a client and prospective client, defrauding investors, and submitting false information on SEC filings. *See* SEC, Litigation Release No. 25171, SEC Charges Investment Adviser and His Advisory Business for Misappropriating More than $1 Million from a Client and Prospective Client and Defrauding Investors (Aug. 17, 2021), https://www.sec.gov/litigation/litreleases/lr-2517.

125 *See* SEC, Litigation Release No. 25251, SEC Charges Financial Adviser with Stealing Investor Funds to Pay off Credit Cards, Buy Gold Coins (Nov. 1, 2021), https://www.sec.gov/litigation/litreleases/lr-25251; *see also S.E.C. v. Welsh* Complaint, Case No. 2:21-cv-19387 (D.N.J. Oct. 28, 2021), https://www.sec.gov/files/litigation/complaints/2021/comp25251.pdf.. The Department of Justice pursued parallel criminal charges against the same individual. *See* Department of Justice, "Bergen County Investment Advisor Arrested for Stealing Millions from Clients", (Oct. 28, 2021), https://www.justice.gov/usao-nj/pr/bergen-county-investment-advisor-arrested-stealing-millions-clients.

- In September 2021, Jason Rhodes, the co-founder, chief investment officer, and chief compliance officer for Sentinel Growth Fund Management, LLC ("Sentinel"), was sentenced to 48 months in prison for securities fraud, wire fraud, investment adviser fraud, and conspiracy charges. Those charges relate to Rhodes's participation in a scheme to defraud over 25 investors in Sentinel out of more than $25 million by lying to the investors and using investor funds for his own personal use, and to make repayments to earlier investors in a Ponzi-like manner.[126]

- In April 2019, the SEC charged an individual and several entities he controlled with operating a Ponzi scheme that defrauded his investment advisory clients out of $7 million. The SEC alleged that the individual provided investment advice to school district employees, hospital employees, veterans, and neighbors, most of whom were unsophisticated investors. According to the complaint, the individual had his own California-registered investment adviser, and through that firm, offered clients the opportunity to invest in tax-free "private placements" that purportedly provided quarterly dividends of about 5 percent. The complaint alleges that, in reality, there were no private placements. The complaint alleged the individual was simply running a Ponzi scheme by taking new investor money and using it to pay quarterly dividends to existing investors and his personal expenses. According to the complaint, the individual also offered investors the opportunity to invest in his farm, but investor funds in these ventures were commingled with investments in his advisory firm and used as part of the Ponzi scheme fraud as well.[127]

B. Vulnerabilities

*i) **Regulatory Vulnerabilities***

Lack of Comprehensive and Uniform AML/CFT Obligations

"Investment advisers" presently are not included in the definition of "financial institution" under the BSA or its implementing regulations.[128] This means that, although they have Form 8300 obligations to report cash transactions above $10,000, investment advisers typically are not subject to most of the AML/CFT program, recordkeeping, or reporting obligations that apply to banks, broker-dealers, and certain other financial institutions.[129] With limited exceptions (*e.g.,* licensed as a bank), investment advisers are not required to maintain an AML/CFT program (consisting of internal controls, an AML/CFT officer, independent testing, and employee training), and do not have independent SAR filing, customer due diligence (CDD), or customer identification program (CIP) obligations. These are key elements of AML/CFT compliance through which an investment adviser would identify and report to law enforcement and regulators a client, investor, or transaction that may be associated with illicit finance activity.

126 Department of Justice, "Co-Founder Of Investment Fund Sentenced To 4 Years In Prison For Defrauding Investors Of Over $25 Million", (Sep. 1, 2021), https://www.justice.gov/usao-sdny/pr/co-founder-investment-fund-sentenced-4-years-prison-defrauding-investors-over-25. Based on Rhodes's guilty plea in the criminal case, the SEC barred him from association with any investment adviser, broker, dealer, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization. *See* In the Matter of Jason B. Rhodes, Administrative Proceeding File No. 3-20632 (October 22, 2021).

127 *See* SEC, Litigation Release No. 24461, SEC Charges San Diego-Based Investment Adviser with Running a Ponzi Scheme (Apr. 26, 2019), https://www.sec.gov/litigation/litreleases/lr-24461. The individual also pleaded guilty to state criminal charges for securities fraud and grand theft, and was sentenced to 12 years in prison. *See* California Department of Insurance, "Poway conman sentenced to 12 years in prison for $7 million Ponzi scheme targeting seniors," (Jul. 23, 2020), https://www.insurance.ca.gov/0400-news/0100-press-releases/2020/release068-2020.cfm.

128 *See* 31 C.F.R. § 1010.100(t).

129 Investment advisers are, like any other "person," subject to an obligation to file Form 8300. 31 C.F.R. § 1010.330(a)(1)(i), (e)(1); 26 C.F.R. § 1.6050I–1(e).

As noted above, some investment advisers may perform certain AML/CFT functions if the entity is also a registered broker-dealer (*i.e.*, a dual registrant), is a bank, or is an operating subsidiary of a bank;[130] other investment advisers are affiliates of banks or broker-dealers that may implement an enterprise-wide AML/CFT program that would include that investment adviser. A Treasury analysis of Form ADV data found that approximately three percent of RIAs were dually registered as a broker-dealer or licensed as a bank, and that these entities held about 10 percent of the AUM held by all RIAs.[131] The same analysis found that approximately 20 percent of RIAs, representing approximately 75 percent of the total AUM of RIAs, were affiliated with either a bank or broker-dealer.

In other circumstances, an investment adviser may perform AML/CFT functions via contract with a broker-dealer (*e.g.*, CIP for joint customers) or other financial institution, such as when the adviser advises an open-end registered investment company (*e.g.*, mutual fund). For instance, some RIAs have already implemented voluntary AML/CFT programs pursuant to the SIFMA No-Action Letter under which the staff of the SEC's Division of Trading and Markets stated that it would not recommend enforcement action if a broker-dealer relies on RIAs to perform some or all aspects of the broker-dealer's CIP obligations or the portion of CDD requirements regarding beneficial ownership requirements for legal entity customers, provided that certain conditions are met, including that the RIA implements its own AML/CFT program.[132] Mutual funds, which are advised by approximately 10 percent of RIAs[133] and hold approximately $22.1 trillion in assets,[134] are also subject to AML/CFT obligations under the BSA and its implementing regulations.[135]

Outside of these circumstances, some investment advisers have voluntarily implemented certain AML/CFT measures, such as CDD or other CIP requirements. However, because these programs are not required by any regulations under the BSA, advisers have wide discretion in what information to request from their clients and private fund investors. Additionally, RIAs and ERAs are not examined for compliance with voluntary AML/CFT measures, so advisers who voluntarily adopt such measures may not be made aware of deficiencies or gaps in their programs via examination. In addition, there are limited enforcement mechanisms under the BSA to pursue against an adviser for failing to implement such measures.

While the programs discussed above provide some AML/CFT coverage for parts of the investment adviser industry, they mean that investment advisers providing the same financial services have differing AML/CFT obligations. For example, depending on corporate structure, policies and practice, stand-alone investment advisers are likely subject to different AML/CFT compliance approaches than investment advisers that are part of a bank or financial holding company; and an investor or client seeking to obscure the origin of its funds, or its identity can choose an investment adviser that has no AML/CFT obligations.

The fact that investment advisers are not currently BSA-defined financial institutions also limits the ability of investment advisers to provide highly useful information to law enforcement, regulators, and other relevant authorities. For instance, because they are not BSA-defined financial institutions, investment advisers are not afforded the protection from liability (safe harbor) that applies to financial institutions

130 *See supra*, n. 2.

131 *See supra*, n. 9.

132 *See* SIFMA No-Action Letter, *supra* n. 3.

133 Information derived from a Treasury review of Form ADV information, *supra*, n. 9.

134 According to the Investment Company Institute *2023 Investment Company Factbook*, as of December 31, 2022, U.S. mutual funds held approximately $22.1 trillion in AUM, while ETFs held approximately $6.4 trillion in AUM. Investment Company Institute, *2023 Investment Company Factbook*, p. 2, https://www.ici.org/system/files/2023-05/2023-factbook.pdf.

135 *See supra* n. 50.

when filing SARs.[136] investment advisers are able to file voluntary SARs, without the safe harbor, they face increased legal risk from customers or other counterparties. Investment advisers are also currently unable to receive and respond to law enforcement requests for information under Section 314(a) of the USA PATRIOT Act as these information-sharing provisions apply only to BSA-defined financial institutions.[137]

Additionally, investment advisers, or associations of investment advisers, that are not BSA-defined financial institutions cannot voluntarily share information under Section 314(b) of the USA PATRIOT Act. Moreover, at present, existing BSA-defined financial institutions are limited in their ability to share information potentially related to money laundering or terrorist financing with investment advisers (and vice versa), because investment advisers are not BSA-defined financial institutions.[138]

Non-AML/CFT Regulatory Exemptions

Some of the existing registration exemptions result in limited reporting requirements for investment advisers and investment funds that service wealthy and financially sophisticated[139] individuals and institutional investors who invest in private investment companies. While these exemptions may be consistent with the investor protection purpose of the Advisers Act and Company Act and the scope of the Securities Act, these wealthy investors may be the same individuals or entities that present higher risks for using investment advisers to place and hide illicit proceeds.

Exemptions for PIVs in CDD Rule and Beneficial Ownership Information Reporting Rule

Under the Corporate Transparency Act, many PIVs are exempt from having to disclose their beneficial owners to FinCEN.[140] Similarly, FinCEN's CDD Rule requires covered financial institutions to identify the beneficial owners of legal entity customers, but excludes PIV customers advised by certain financial institutions, including a financial institution regulated by a federal functional regulator or a bank regulated by a State bank regulator (this includes RIAs).[141] Moreover, if a covered financial institution's customer is a PIV advised by a type of financial institution not covered by this exclusion, the covered financial institution is only required to identify a single individual with significant responsibility to control, manage, or direct the PIV to comply with the CDD Rule's beneficial ownership identification requirement.[142] In practice, this would generally not result in identification of the underlying investors in a private fund, which, as explained above, may be limited partners whose ability to influence the fund's operations is limited by contractual agreement.

These exemptions were intended to prevent entities that already disclosed control or ownership information to the U.S. government from having a duplicative requirement, or to apply to entities where ownership fluctuates frequently, making collection of ownership information very difficult.[143] However, for

136 31 U.S.C. § 5318(g)(3)(A).

137 *See* 31 C.F.R. § 1010.520.

138 *See* 31 C.F.R. § 1010.540.

139 Certain private funds are only available to qualified purchasers, who are generally defined as investors that are financially sophisticated. "Qualified purchaser" is defined in section 2(a)(51) of the Company Act. *See* 15 U.S.C. § 80-2(a)(51).

140 *See* 31 U.S.C. § 5336(a)(11)(B)(xviii); 31 C.F.R. § 1010.380(c)(2)(xviii). To the extent applicable, PIVs operated or advised by ERAs described in section 203(m) of the Advisers Act (private fund advisers with less than $150 AUM), are not included in the exemption. *See also* 31 U.S.C. § 5336(b)(2)(C); 31 C.F.R. § 1010.380(b)(2)(iii) (requiring foreign PIVs otherwise exempt to provide information about one individual who exercises substantial control over the entity).

141 *See* 31 C.F.R. § 1010.230(e)(2)(xi).

142 *See* 31 C.F.R. § 1010.230(e)(3)(i).

143 *See, e.g.*, FinCEN, *Beneficial Ownership Information Reporting Requirements*, Notice of Proposed Rulemaking, 86 Fed. Reg. 69920, 69928 (Dec. 8, 2021); FinCEN, *Customer Due Diligence Requirements for Financial Institutions*, Final Rule, 81 Fed. Reg. 29398, 29415 (May 11, 2016).

investment advisers, the practical impact of these exemptions would be that an adviser would generally not be required to identify the underlying investors in private funds (including foreign legal entities used as investment vehicles).

Broker-Dealers Shifting to IA Registration

In recent years, some broker-dealers have terminated or withdrawn their broker-dealer registration and instead registered as IAs.[144] As a result, an increasing number of advisory clients and their assets may not have direct customer relationships with entities subject to comprehensive AML/CFT obligations.

ii) ***Advisory Activities Built on Segmentation and Cross-Border Activity***

Reliance on Third- Party Administrators Subject to Varying Regulatory Obligations

It is common for RIAs that manage private funds to contract with third-party administrators for a range of administrative tasks, including investor due diligence and identity verification. Some funds, regardless of AUM size, may seek to outsource many compliance and reporting functions to limit administrative costs and seek to transfer liability. While some third-party administrators are located in the United States and may be affiliated with larger financial institutions, others are located in offshore financial centers where private funds are routinely domiciled, usually for tax or other commercial reasons unrelated to AML/CFT regulation, such as the Cayman Islands.[145]

The due diligence and verification practices of these offshore fund administrators are not uniform and may vary based upon the requirements of the local regulatory regime as well as the requirements of the fund's adviser. While some investment advisers may rely on these administrators to manage their perceived risk or to comply with local regulatory requirements, the piecemeal review of investor information is not a substitute for comprehensive AML/CFT compliance measures. These third-party administrators may also face legal and regulatory challenges in receiving and verifying documentation from foreign legal entity investors in funds they service. Further, effective AML/CFT supervision of fund administrators based outside the United States often is still nascent, with foreign regulators taking few enforcement actions to date.[146]

AML/CFT Obligations Not with Client-Facing Entity

Investment advisers engage in trading or transactional activities on behalf of their clients through relationships with financial institutions that are subject to AML/CFT obligations, such as broker-dealers and banks, among others. For instance, as discussed above, the Custody Rule under the Advisers Act requires RIAs that have custody of client funds or securities generally to maintain those funds and securities with a qualified custodian, defined primarily to encompass BSA-defined financial institutions.[147]

144 According to the SEC, the number of broker-dealers declined from over 6,000 in 2005 to less than 4,000 in 2018, while the number of IAs increased from approximately 9,000 in 2005 to over 13,000 in 2018. See *Regulation Best Interest: The Broker-Dealer Standard of Conduct*, Final Rule, 84 Fed. Reg. 33318, 33412 (July 12, 2019). This may be occurring because the broker-dealer may view the typical IA compensation (a flat fee or a percentage of assets managed) as more lucrative than the broker-dealer compensation (fees from trades executed for clients). There are also instances of firms that have been disbarred from acting as broker-dealers that are now registering as IAs to maintain their involvement (and clients) in investment activities.

145 *See* Caribbean Financial Action Task Force Mutual Evaluation of the Cayman Islands (Mar. 2019), p. 26, https://www.fatf-gafi.org/media/fatf/documents/reports/mer-fsrb/CFATF-Cayman-Islands-Mutual-Evaluation.pdf. While a fund may be domiciled or registered in the Cayman Islands, the adviser managing that fund may be located in the United States and/or registered with the SEC.

146 *Id.*, pp. 135-139 (Cayman Islands received the lowest possible rating for supervision). Additionally, fund administrators in the Cayman Islands filed only 37 SARs in 2017. *Id.*, p. 116.

147 17 C.F.R. § 275.206(4)-2. The SEC recently proposed amendments to the Custody Rule. *See supra* n. 69.

While investment advisers often do not take possession of financial assets, they nonetheless may have a more direct relationship with the clients they advise and thus are often better positioned than custodians to obtain the necessary documentation and information from and about the client that is relevant for AML/CFT purposes.[148] If some of these assets include the proceeds of illegal activities, or are intended to further such activities, an investment adviser's AML/CFT program could help discover such issues and prevent the client from further using the U.S. financial system, while reporting such information for law enforcement purposes. For example, in some cases, an investment adviser may be the only person or entity with a complete understanding of the source of a client's invested assets, background information regarding the client, or the objectives for which the assets are invested.

Other market participants may, for example, hold and trade assets in an account controlled by an adviser, but these parties, as intermediaries, often rely solely on the investment adviser's instructions and lack independent knowledge of the adviser's clients. Further, an investment adviser may use multiple broker-dealers or banks for trading and custody services, making it difficult for one financial institution in the chain to have a complete picture of an investment adviser's activity or to detect suspicious activity involving the investment adviser. Without complete information, such an institution may not have sufficient information to file a SAR, or it may be required to file a SAR that only has partial information concerning the investment adviser's transactions on behalf of a particular client. This limits the ability of law enforcement to identify illicit activity that may be occurring through investment advisers.

Inability to Identify the Ultimate Beneficial Owner or Client

Some investment advisers provide advisory services to clients that structure their investments through several layers of U.S. and foreign legal entities or arrangements, such as limited liability companies (LLCs) and trusts, often referred to colloquially as "shell companies." Such structures may be used for legitimate tax reasons, but can be used to obfuscate the source of funds for either natural person or legal entity investors and obscure unlawful conduct.

An additional challenge is the use of nominee arrangements, in which an intermediary (often a foreign bank or overseas custodial service provider) agrees to be identified as the nominal investor and essentially acts as a "shield" for individuals who want to make investments without disclosing their identities or source of funds. These nominee arrangements can be used in connection with other intermediaries in the ownership chain (*e.g.*, the nominee may be acting on behalf of a foreign asset manager, who in turn has the relationship with an illicit actor or politically exposed person (PEP)). While these nominee arrangements often can have legitimate purposes, if they are not explicitly identified in required reports or records, they can be abused to obscure potentially illicit funds and make it extremely difficult (if not impossible) for regulators to identify and fully understand the nature and extent of illicit finance risks in this sector. As of Q4 2022, private fund advisers reporting on Form PF noted that they did not know, and could not reasonably obtain information about, the non-U.S. beneficial ownership of approximately $284 billion in private fund AUM.[149]

In addition, data privacy or other laws or regulations in effect in offshore jurisdictions, or contractual obligations, may impact how certain customer information is shared with investment advisers, broker-dealers, and other financial institutions (and by extension, U.S. law enforcement and regulators). While

148 *See* SIFMA No-Action Letter *supra* n. 3 (incoming letter to SEC stating "RIAs often have the most direct relationship with the customers they introduce to broker-dealers and are best able to obtain the necessary documentation and information from and about the customers").

149 *See supra* n. 4.

some investment advisers are introduced to new foreign investors by foreign entities subject to AML/CFT obligations (such as a broker-dealer), this practice is not consistent, as other introducers or promoters may be individuals with no AML/CFT obligations.

Common Use of Representations Where LP Beneficial Ownership Cannot Be Verified

Where an RIA is unable to identify the ultimate beneficial owner or source of funds, the RIA may fulfill any client due diligence or identification requirements (its own or those of counterparties) by receiving a representation from a third party that the beneficial owner is (1) not on a U.S., United Nations, or foreign sanctions list and (2) not a PEP. However, this representation does not enable the RIA (and those regulated financial institutions providing access to the U.S. financial system) to assess the illicit finance risk associated with the beneficial owner of its client. This approach necessarily fails to capture risks unrelated to PEP or sanctioned status, such as a source of wealth from illicit or non-transparent means. Even with respect to PEP or sanctions risks, a negative representation framing would not necessarily permit the financial institution to ascertain the degree of related risk (*e.g.*, being an associate or potential proxy for an individual presenting such risks). This risk is heightened in the context of the use of nominee arrangements described above. Further, while the RIA may have a contractual recourse against the third party if its representations turn out to be false, the U.S. government would not be able to address the harm to financial transparency and national security outside of criminal prosecution.

iii) ***Business Practices That Promote Secrecy of Client Information***

There are commercial and regulatory incentives in the investment adviser business to keep client information private. First, investment advisers are hesitant to disclose the identities of their clients to other financial institutions because the information helps them maintain market share and competitiveness. For instance, some investment advisers may be reluctant to have a broker-dealer contact their clients because they view the broker-dealer as a competitor.[150]

C. Consequences

Exploitation of the investment adviser sector by illicit actors is especially consequential because of the vast sums managed by investment advisers. For instance, private funds, which are not subject to comprehensive AML/CFT obligations, hold approximately $20 trillion in AUM.[151]

Additionally, because of the nature of the investment adviser business, the illicit finance risk of investment advisers will pass to broker-dealers and qualified custodians, who may lack the ability to assess the client of the investment adviser and the client's source of funds (or, with respect to a private fund, the private fund's underlying investors and their sources of funds). For instance, several of the broker-dealer AML/CFT enforcement actions identified in the 2022 National Money Laundering Risk Assessment resulted from the actions of complicit investment advisers.[152] As advisers do not have an independent SAR filing obligation, their prime brokers or custodians may file with respect to the clients of those advisers, but the limited number of filings by those entities on illicit finance tied to investment adviser clients further reduces visibility into potential investment adviser links to illicit activity.

150 *See* SIFMA No-Action Letter, *supra* n. 3.

151 *See supra* n. 4.

152 *See* Treasury, *2022 National Money Laundering Risk Assessment*, pp. 54-56.

4. EXISTING MITIGATION MEASURES

A. AML/CFT Measures

While investment advisers are generally not subject to any comprehensive AML/CFT requirements, they may in some instances carry out certain AML/CFT functions, such as CIP, CDD, and SAR filing. Some investment advisers may perform certain AML/CFT functions if the entity is also a registered broker-dealer (*i.e.*, a dual registrant), is a bank, or is an operating subsidiary of a bank;[153] other investment advisers are affiliates of banks or broker-dealers, which may implement an enterprise-wide AML/CFT program that would include that investment adviser. An investment adviser may also perform AML/CFT functions via contract with a broker-dealer (*e.g.*, CIP for joint customers) or other financial institution, such as when the adviser advises an open-end registered investment company (*e.g.*, mutual fund).

Outside of these circumstances, some RIAs have voluntarily implemented certain AML/CFT measures, such as due diligence or identification requirements. However, these voluntary programs give RIAs wide discretion in what information to request, and are not subject to any regulations under the BSA. Further, to the extent these RIAs do not integrate comprehensive AML/CFT program requirements into their broader compliance programs, they may lack familiarity with and understanding of the goals and objectives of the AML/CFT regime.

B. Non-AML/CFT Rules and Regulations

RIAs are subject to various SEC rules and regulations governing, among other things, their marketing and disclosures to clients, best execution for client transactions, and disclosures of conflicts of interest and disciplinary information, among others. However, these regulatory requirements are not designed to explicitly address AML/CFT risks; they are designed to protect clients against fraud, misappropriation, or other illegal conduct by an RIA. In some circumstances, they may require the collection or disclosure of information that imposes restrictions similar to some AML/CFT measures.

- *Custody Rule*. Qualified custodians also acting as the executing broker may be in a position to detect and report IA theft, fraud, or market manipulation, where the transactions themselves may be suspicious. Without identifying information about the IA client and their source of funds, however, qualified custodians will be limited in their ability to detect other types of illicit proceeds associated with that IA client.

  Additionally, an RIA may use multiple qualified custodians or multiple brokers. This means that one qualified custodian or broker may not have the complete picture of an RIA's activity. The qualified custodian or broker may not have sufficient information to file a SAR, or will file a SAR with only partial information on transactions, hindering law enforcement from understanding the full scope of a money laundering scheme.[154]

- *Compliance Rule*. While the Compliance Rule offers the SEC a helpful cause of action for failure to implement policies and procedures to prevent violations of the Advisers Act or the rules adopted thereunder, the Compliance Rule does not address the requirements of the BSA or impose explicit requirements for an Office of Foreign Assets Control (OFAC) compliance program.[155]

153 *See supra*, n. 2.

154 *See, e.g.*, SEC, *Commission Interpretation Regarding Standard of Conduct for Investment Advisers*, Investment Advisers Act Release No. 5248 (Jun. 5, 2019), 84 Fed. Reg. 33669, 33674-75 (Jul. 12, 2019) (discussing an investment adviser's duty to seek best execution of a client's transactions where the investment adviser has the responsibility to select broker-dealers to execute client trades).

155 While OFAC sanctions requirements are separate from AML/CFT requirements, investment advisers, like other U.S. persons, must comply with OFAC sanctions. Some investment advisers may have policies and procedures to comply with OFAC sanctions.

- *Books and Records Rule*. The Advisers Act requires an RIA to maintain certain books and records, as prescribed by the SEC. Under the books and records rule adopted under the Advisers Act, an RIA is required to keep certain books and records that relate to its investment advisory business. While these records may be useful for demonstrating fraud, theft of client assets, or other violations of law by an RIA, if they do not pertain to the client's beneficial owner or source of wealth, then they will have limited utility in detecting and mitigating the risk that an RIA could facilitate the laundering of illicit proceeds.

C. Enforcement

i) ***Federal Enforcement***

Civil Enforcement. The SEC investigates and pursues enforcement actions against investment advisers that violate the federal securities laws and regulations promulgated thereunder. However, as noted above, investment advisers (with some exceptions) generally do not have obligations under the BSA. The SEC has promulgated regulations for broker-dealers to comply with certain BSA regulations (including the CDD Rule)[156] and has pursued enforcement action against broker-dealers that failed to apply AML/CFT obligations to their investment adviser customers.[157] While this may capture suspicious activity by the investment adviser (such as market manipulation or fraud), it would be less likely to identify suspicious activity by an investment adviser's client, particularly if activity routed through that broker-dealer involved purchases or sales consistent with routine trading activity but the funding of such trading was the result of illicit proceeds.

Criminal Prosecution. The Department of Justice actively pursues criminal violations of federal law by investment advisers, including violations of anti-money laundering, securities, tax, and anti-corruption laws. Based on cases identified for purposes of this assessment, these criminal prosecutions commonly involve investment fraud or theft of client assets by complicit investment advisers. There are fewer cases of investment advisers being criminally charged for facilitating the movement of illicit proceeds generated by a separate crime.

There are several barriers to criminally prosecuting investment advisers for money laundering. Unlike other financial intermediaries, investment advisers generally do not have BSA obligations. This means, for instance, that bringing charges against an adviser for willfully failing to file SARs with respect to a client involved in criminal activity may present challenges. Additionally, because an investment adviser is not required to engage in specific levels of diligence on clients' sources of wealth, proving that an investment adviser had knowledge that funds were derived from criminal activities can be particularly challenging. Further, law enforcement does not receive SAR filings that may also help identify criminal conduct.

156 The SEC enforces 17 C.F.R. § 240.17a-8 (Rule 17a-8), which obligates a broker-dealer to comply with certain BSA regulations, and gives the SEC authority to bring enforcement actions against broker-dealers that violate the BSA's reporting, recordkeeping, and record retention requirements, including the SAR and CIP rules. In addition to federal law, broker-dealers are required to comply with applicable self-regulatory organization rules, such as FINRA Rule 3310 (Anti-Money Laundering Compliance Program). The SEC has also promulgated a rule that requires registered investment companies to adopt and implement written policies and procedures reasonably designed to prevent violation of the federal securities laws, defined to include the BSA. *See* 17 C.F.R. § 270.38a-1.

157 *See*, *e.g.*, *Securities and Exchange Commission v. Charles Schwab & Co., Inc*, No. 18-Civ-3942 (N.D. Cal. Jul. 2, 2018), https://www.sec.gov/litigation/litreleases/2018/lr24189.htm. The SEC has also pursued enforcement action against mutual funds for failure to comply with the BSA and its implementing regulations. *See e.g.*, DWS Investment Management Americas Inc., Investment Company Act Rel. No. 6431, (Sept. 25, 2023).

ii) ***State Enforcement***

Like their federal counterparts at the SEC, state and territorial authorities responsible for overseeing state-registered entities are primarily focused on protecting investors and the overall securities market in their jurisdictions. Common areas of focus include elder fraud and exploitation, commodities and precious metals, internet and social media solicitations, and digital asset-related activities. In FY 2021, state regulators reported more than 1,661 securities-related enforcement actions as a whole, over 80 percent of which were civil or administrative enforcement actions.[158] These included 267 enforcement actions against investment advisers and IARs.

While state regulators have sufficient authority to pursue civil and criminal action for violations of state securities laws, similar to their federal counterparts, generally state-registered investment advisers do not have AML/CFT obligations. State regulators are also incentivized to apply those resources to fraud and other crime affecting investors in their states, and not activity that may originate in another U.S. state or outside of the United States, and does not harm local investors.

D. Whistleblower Reward Programs

There are several "whistleblower" programs that offer rewards for voluntary disclosure of violations of federal securities laws and regulations and AML/CFT laws and regulations. For example, the SEC Whistleblower Program offers awards to eligible whistleblowers who provide original information that leads to successful SEC enforcement actions with total monetary sanctions exceeding $1 million. Additionally, FinCEN's implementation of its Anti-Money Laundering and Sanctions Whistleblower Program is currently underway. Under this program, eligible whistleblowers will receive monetary awards amounting to 10 to 30 percent of penalties collected by Treasury or the Department of Justice if their original information leads to qualifying actions involving violations of covered statutes such as the BSA and the International Emergency Economic Powers Act. These programs can create incentives for non-government actors to report illicit finance activity even in the absence of comprehensive AML/CFT requirements.

158 *See* NASAA, 2022 Enforcement Report, https://www.nasaa.org/wp-content/uploads/2021/09/2021-Enforcement-Report-Based-on-2020-Data-FINAL.pdf.

5. RESIDUAL RISKS

Based on research to date derived from cases, BSA filings, public reporting, and discussions with law enforcement and the staff at the SEC, we assess there is a material risk investment advisers could be misused for illicit finance, although the degree of risk is not uniform across the sector. Given the aforementioned attributes of the advisory business and the lack of comprehensive AML/CFT requirements for investment advisers, some money launderers may see some investment advisers as a lower-risk way to enter the U.S. financial system. For example, this could occur when a money launderer moves funds derived from illegal activity into a brokerage account of an adviser (including an omnibus account) or other financial account that is advised by an investment adviser. In this situation, although the broker-dealer would have AML/CFT obligations under the BSA, it may be difficult for the broker-dealer to discharge its AML/CFT duties as effectively as the investment adviser (*e.g.*, to detect and report suspicious activity), given the investment adviser would have the most relevant information (client identity and source of wealth).

The highest illicit finance risk lies among ERAs, where there are either more limited reporting requirements (under the federal securities laws) or none at all. Private funds, such as hedge funds or private equity funds, are not registered with the SEC, and may accept investors without knowing the ultimate beneficial owners or sources of funds. Further, approximately half of these funds are domiciled outside the United States, often in jurisdictions where the practice is to rely on representations and warranties from intermediaries who represent investors when it is not possible to obtain investor identity and source of funds information.

Venture capital funds are at risk of exploitation because of their limited transparency (to the extent that they are managed by ERAs and are unregistered), as evidenced by exposure to the types of misuse noted above, particularly by Russian oligarchs and their associates. Additionally, venture capital funds have been identified as an avenue for foreign state adversaries to access technology and companies with significant national security implications. Finally, as noted above, advisers to venture capital funds are able to rely on a registration exemption regardless of their AUM.

While RIAs may be more transparent and are subject to more regulatory requirements than ERAs, those that are not dually registered as or affiliated with a bank or broker-dealer present the next highest illicit finance risk, as existing SEC registration and reporting alone do not significantly mitigate the risks addressed by AML/CFT requirements. One quarter of the 15,000 RIAs advise private funds, which are vulnerable to exploitation as described above, and the other asset management and advisory services RIAs offer can be exploited by illicit actors, particularly for legal entity investors who obscure their owner or the underlying source of funds.[159] Those RIAs that are dually registered as or affiliated with a bank or broker-dealer may be more likely to implement AML/CFT obligations with respect to their investment advisory clients as part of their enterprise-wide risk management. This is a relevant risk mitigating factor, but there is a lack of consistency across the industry, which enables regulatory arbitrage. Banks and broker-dealers (that are not dually registered as RIAs) also may custody funds or conduct transactions in the name of the RIA and be unable to identify the underlying clients.

159 Even without offering private funds, an RIA can provide a range of investment options, such as direct investment in private companies, or the purchase of specific stocks or bonds on behalf of a client.

Approximately 81 percent of state-registered advisers have only one or two employees,[160] and depending on the state with which they are registered, may be subject to fewer reporting requirements (compared to RIAs). However, state-registered investment advisers *must* register with the SEC above a certain AUM threshold. Given these factors and the limited instances Treasury has identified in which state-registered advisers have been misused to move illicit proceeds or funds associated with sanctioned persons, additional information collection to support regulatory action would be beneficial.

Single family offices are at a relatively lower risk for illicit finance. Despite their exemption from registration and regulation under the Advisers Act, they cannot have advisory clients outside of family members and some limited others, so ascertaining the source of funds should be relatively simple. Additionally, Treasury has identified very few case examples or other information indicating family offices are at risk of being misused to facilitate illicit finance or other criminal activity.

160 *See* NASAA 2023 Annual Report, p. 5, *supra* n. 10.

6. ANNEXES

Annex 1: Methodology

The terminology and methodology of this sectoral risk assessment is based in part on the guidance of the Financial Action Task Force (FATF), the international standard-setting body for AML/CFT safeguards. The following concepts are used in this risk assessment:

Threats: For purposes of this assessment, threats are the predicate crimes or threat actors (individuals, groups, and entities) that are associated with illicit finance involving this sector.

Vulnerabilities: Vulnerabilities are what facilitate or create the opportunity for illicit finance. They may relate to a specific feature of a financial sector or product including market structure and entry, channels of distribution, or a weakness in law, regulation, supervision, or enforcement.

Consequences: Consequences refers to the impact or harm that illicit finance may cause and includes the effect of the underlying criminal and terrorist activity on financial systems and institutions, as well as the economy and society more generally. The consequences of money laundering or terrorism financing may be short or long term in nature and relate to populations, specific communities, the business environment, or national or international interests, as well as the reputation and attractiveness of a country's financial sector.

Risk: Risk is a function of threat, vulnerability, and consequence. It represents an overall assessment, taking into consideration the effect of mitigating measures including regulation, supervision, and enforcement.

Annex 2: Securities and AML/CFT Regulatory Requirements for IAs and Other Entities Involved in IA Activity

Investment Advisers

Entity	Registration?	Reporting?	Examination?	AML/CFT Obligations Under the BSA?
SEC-Registered Investment Adviser	Yes (SEC)	Yes (SEC)	Yes (SEC)	No. An RIA may implement at least some AML/CFT obligations if it is dually registered as a broker-dealer or licensed as a bank or is an operating subsidiary of a bank, or if it is part of a large financial holding company and subject to an enterprise-wide AML program, or performs AML measures contractually.
Exempt Reporting Advisers	No (exempt from SEC registration)	Yes (SEC)	Yes (SEC)	No. A private fund adviser may implement certain AML/CFT obligations contractually or have a voluntary AML program.
State-Registered IAs	Yes (State authorities)	Yes (State authorities)	Yes (State authorities)	No.
Foreign IAs	No	No	No	Not under U.S. law, but may have similar obligations under laws of foreign jurisdictions where they operate.

Other Entities Involved in IA Activity

Entity	Registration?	Reporting?	Examination?	AML/CFT?
Prime Broker	Yes	Yes	Yes	Yes (usually a bank or broker-dealer)
Qualified Custodian	Yes	Yes	Yes	Yes (must be a bank (U.S. or foreign), broker-dealer, or futures commission merchant).
Fund Administrator	No	No	No	Not in the U.S., but some foreign jurisdictions (Ireland, Cayman Islands) do impose AML requirements. Also may have AML requirements if fund administrator is part of a bank or broker-dealer.
Limited Partner	No	No	No	No
General Partner	No	No	No	No
Auditor	Yes (PCAOB)	Yes (PCAOB)	No	No

Annex 3: Summary Information Requested on Form ADV

Form ADV has five parts: 1A, 1B, 2A, 2B, and 3, as well as additional Schedules. RIAs, state-registered IAs, and ERAs all must fill out at least some of Form ADV and provide periodic updates. SEC-registered entities submit the form to the SEC, while state-registered entities submit the form to their respective state regulator(s). A summary of the key provisions is below.

- Part 1A asks about the investment adviser's business including identifying information, basis for registration, and number of employees. It also asks about the IA's types of clients, such as individuals, investment companies, pooled investment vehicles; assets under management; the types of advisory services each IA offers; and questions about where funds are custodied. Part 1A also contains several supplemental schedules. Schedules A through C include questions about direct owners, executive officers, and indirect owners of the investment adviser. Schedule D includes questions about private funds, to include the types of private funds, the associated custodian and prime broker, the fund administrator, and auditor.
- Part 1B asks additional questions required by state securities authorities.
- Part 2A generally requires advisers to provide copies to advisory clients of the narrative brochures that IAs must create and deliver about the advisory firm. This item does not apply to ERAs.
- Part 2B generally requires advisers to create and deliver brochure supplements containing information about certain supervised persons. This requirement applies to all RIAs and IAs seeking to register with the SEC, but it does not apply to ERAs.
- Part 3 requires advisers to create a relationship summary (Form CRS) containing information for retail investors (defined as natural persons). This item applies to all IAs registering or registered with the SEC, but does not apply to ERAs.

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