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April 15, 2024
Financial Crimes Enforcement Network
P.O. Box 39
Vienna, VA 22183
Attention: Director Andrea Gacki

Re: AML Requirements for RIAs and ERAs (RIN: 1506-AB58) (Docket Number FINCEN-2024-0006)

Dear Director Gacki,

The Anti-Corruption Data Collective (ACDC) applauds the plan of the Financial Crimes Enforcement Network (FinCEN) to apply comprehensive anti-money laundering (AML) program requirements to Registered Investment Advisers (RIAs) and Exempt Reporting Advisers (ERAs), as described in the agency's February 14, 2024 notice of proposed rulemaking (NPRM).[1] ACDC welcomes the opportunity to submit public comments on this proposal and has chosen to limit its submission to the topic of advisers to private funds. ACDC believes that hedge funds, private equity funds, venture capital funds, and similar vehicles present the most urgent, serious, and complex illicit finance challenge facing the agency and the country. For that reason, this comment does not discuss other types of investment advisers that would be covered by the proposed rule.

ACDC is a collective of experts and advocacy organizations that makes innovative use of publicly available data to study transnational corruption flows and develop effective policy solutions. It is a project of the Fund for Constitutional Government ("FCG"), a 501(c)(3) nonprofit corporation based in Washington, DC.

ACDC supports the proposed rule, which would require RIAs and ERAs to adopt an AML compliance program accompanied by training, testing, and an identified responsible officer; implement internal controls, including the filing of suspicious activity reports; and participate in information sharing programs under Section 314 of the USA PATRIOT Act. ACDC does not object to FinCEN's plan to implement these requirements as soon as possible, with Customer Identification Program (CIP) and beneficial ownership determination requirements to follow in 2025. However, ACDC would like to offer three primary recommendations to strengthen the proposal.

First, ACDC recommends that FinCEN expand the definition of advisers beyond RIAs and ERAs to include two important types of actors not subject to the Investment Advisers Act of 1940, namely managers of family offices and of certain real estate-focused funds.

Second, after the revision of the Customer Due Diligence (CDD) rule by January 2025 and the promulgation of a CIP rule for advisers to be issued jointly by FinCEN and the Securities and Exchange Commission (SEC), FinCEN must, as it intends to, apply beneficial ownership rules

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[1] 89 FR 12108.

that require advisers to determine the natural person beneficial ownership of limited partner investors. It is vital that the threshold for this reporting from pooled investment vehicles be lower than the 25% threshold currently used for bank accounts under the CDD Rule or for reporting companies under the Corporate Transparency Act (CTA).

Third, FinCEN and its Office of Terrorism and Financial Intelligence colleagues should work with partners at the Treasury Department's Investment Security Office and at the SEC to address critical transparency and national security gaps involving private funds that will remain even after the entry into force of AML requirements for advisers to such funds.

The History of FinCEN's Efforts to Regulate Private Funds

FinCEN originally proposed to impose AML obligations on RIAs to private funds in September 2015. That NPRM, which was never finalized, built on earlier 2002 and 2003 efforts to regulate certain advisers and private funds, which were withdrawn in 2008. By 2015, the first round of (withdrawn) proposals had become out of date, as advisers to private funds were brought under a new SEC supervisory framework with the passage of the Dodd-Frank Act of 2010. At the time of the second FinCEN effort in 2015, the SEC's Private Fund Statistics showed that 2,704 advisers managed 25,019 private funds holding $10.1 trillion in gross assets and $6.7 trillion in net assets.[2]

The 2002 and 2003 NPRMs were in response to Section 352 of the USA PATRIOT Act of 2001, in which Congress required FinCEN to promulgate AML program requirements for a variety of classes of financial institutions, including "investment companies other than mutual funds," which would include private funds.[3] In April 2003, FinCEN exempted certain financial institutions including investment companies from AML program requirements for six months, through October 2003.[4] In October 2003, FinCEN issued a second six-month deferral lasting through April 2004, by which point it said it would "complete its work and issue appropriate regulations".[5] The agency has been operating under that temporary six-month deferral for twenty years.

In addition to fulfilling the statutory requirement of Section 352 of the PATRIOT Act, finalization of the rule would address concerns raised by the Financial Action Task Force (FATF). In its 2016 assessment of the United States, FATF found the U.S. to be only partially compliant with several requirements including Recommendation 1, Assessing Risks and Applying a Risk-Based Approach, due in part to the lack of AML obligations for investment advisers.[6]

Unfortunately, FinCEN was unable to finalize the 2015 NPRM. In the time that elapsed, the private funds sector exploded. According to the most recently available private funds statistics analyzed by the SEC, which cover the period through the second quarter of 2023, 3,798 advisers

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[2] https://www.sec.gov/divisions/investment/private-funds-statistics/private-funds-statistics-2015-q3.pdf.
[3] Public Law 107–56.
[4] 67 FR 21110.
[5] https://home.treasury.gov/news/press-releases/po3580.
[6] https://www.fatf-gafi.org/content/dam/fatf-gafi/mer/MER-United-States-2016.pdf.coredownload.inline.pdf.

managed 47,443 private funds holding $20.9 trillion in gross assets and $14 trillion in net assets.[7] During this period of inaction, the size of the unregulated space has doubled.

The Illicit Finance Risk Posed by the Lack of AML Requirements for Advisers to Private Funds – Publicly Documented Cases

While FinCEN should have implemented the 2015 proposal, the silver lining is that the 2024 NPRM is improved in several respects. The discussion of documented cases of illicit financial activity occurring through private funds as well as the analysis of the known risks posed by the sector is much stronger in 2024. The new proposal also covers ERAs, including venture capital firms and advisers managing under $150 million in private fund assets. This is a critical step, for, as FinCEN notes, these venture capital or smaller hedge or private equity funds often pose a higher risk than RIAs managing larger hedge or private equity funds.

Section II, Subsection C of the NPRM, "Illicit Finance Risk Associated With Investment Advisers," does a fine job of summarizing the extensive and wide-ranging examples of activity conducted through private funds that pose illicit finance or national security risk. The expanded treatment of such illicit finance cases in the Treasury Department's February 2024 Investment Adviser Risk Assessment is even more persuasive and overwhelming.[8]

The NPRM details numerous examples of actors tied to Russia or China accessing critical or emerging technologies through private funds, which they may view as a "back door." FinCEN States that "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." FinCEN cites explicit warnings from the Federal Bureau of Investigation that the Chinese government "routinely conceals its ownership or control of investment funds to disguise efforts to steal technology or knowledge." The NPRM also cites Bank Secrecy Act (BSA) reporting to establish the risk of Russian sanctions evasion through private funds, noting that more than 20 U.S. advisers to private funds were identified as "having significant ties to Russian oligarch investors or Russian-linked illicit activities," and that more than 60 additional U.S. advisers have managed private funds "in which identified Russian oligarchs have invested."

The sanctions evasion risk is even greater than the estimated magnitude derived only from identified cases reported to FinCEN under the BSA. Press reporting in the *New York Times*, *Washington Post*, and *Wall Street Journal* reveals that advisers to private funds may not always know the identity of their investors at a beneficial ownership level, are likely unaware of the full extent of their potential exposure to Russia sanctions, and were caught off-guard by the sudden imposition of new sanctions against Russia in response to its invasion of Ukraine in 2022.[9]

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[7] https://www.sec.gov/files/2023q2-private-funds-stats20240109.pdf.
[8] https://home.treasury.gov/system/files/136/US-Sectoral-Illicit-Finance-Risk-Assessment-Investment-Advisers.pdf.
[9] https://thefactcoalition.org/fact-submits-comments-to-the-sec-encouraging-additional-due-diligence-and-reporting-requirements-for-financial-advisors/.

FinCEN's discussion also highlights prominent public corruption cases involving the use of private funds, such the theft of funds from a state investment fund in Malaysia and an oil-related case in Venezuela. Closer to home, FinCEN could also have mentioned a 2020 Justice Department case in which a wealthy executive admitted to using private equity funds to avoid reporting more than $200 million in income as part of an illegal tax evasion scheme.[10]

The Illicit Finance Risk Posed by the Lack of AML Requirements for Advisers to Private Funds – ACDC's Analysis of SEC Data

To illustrate the risks created by a lack of AML requirements for the private fund industry, we at ACDC collected and analyzed publicly available data on the characteristics of private funds currently managed by advisers reporting to the SEC. All investment advisers with at least $150 million in private fund assets under management must register with the SEC as RIAs and subsequently are required to file Form ADV, in which they describe the nature of their assets and management strategy. ERAs, including managers of venture capital funds, also file Form ADV. We accessed bulk data provided through a longstanding Freedom of Information Act (FOIA) request that covers all Forms ADV for all reporting advisers from January 1, 2001 to December 31, 2023.[11] We then processed the data to analyze only private funds managed by investment advisors active as of December 31, 2023, from a related SEC website.[12]

The resultant data contains 56,134 unique private funds managed by reporting advisers and totalling roughly $21 trillion in assets under management. Our dataset includes all private funds, such as private equity funds, hedge funds, real estate funds, venture capital funds, securitized asset funds, and liquidity funds.[13] Importantly, there are several fields in Form ADV that address the ownership of each fund, including the number of beneficial owners at the time of reporting and the percentage of non-U.S. ownership of total assets under management. We use these two fields to create a broader picture of which types of actors are investing through private funds.

Our analysis shows that, on average, private funds that appear in the SEC registry report 172.4 unique beneficial owners. However, we observe 25,387 funds (or 45% of the total sample) that have 10 or fewer beneficial owners and going further, 15,850 funds (28% of the total sample) that list three or fewer beneficial owners. While most private funds have many owners, over one quarter of those funds, including many with significant assets under management, exhibit surprisingly concentrated ownership.

Next, we find that there are 28,070 private funds (50% of the total dataset) that have at least some (more than zero) non-U.S. ownership. If we multiply the percentage of non-U.S. ownership by the total assets under management for each fund, we see that out of $21 trillion in private fund

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[10] https://www.justice.gov/opa/pr/private-equity-ceo-enters-non-prosecution-agreement-international-tax-fraud-scheme-and-agrees.

[11] https://www.sec.gov/foia/docs/form-adv-archive-data.

[12] https://www.sec.gov/help/foiadocsinvafoia.

[13] Our sample includes slightly more funds than the most recent analysis (dated June 30, 2023) issued by the SEC that uses what we presume to be the same underlying source data. Unfortunately, we cannot replicate the SEC analysis, as they do not document the sample selection decisions to arrive at their numbers. However, we are confident that our analysis only includes unique private funds managed by active advisers as of December 31, 2023.

assets under management, $8.4 trillion (40%) is owned by non-U.S. persons. There is a significant amount of foreign cash entering the U.S. financial system and economy through private funds.

Finally, we observe 4,960 unique private funds that both list three or fewer beneficial owners and at least 50% non-U.S. beneficial ownership. These private funds by definition are controlled by foreign individuals. Collectively, these funds with concentrated, non-U.S. beneficial ownership manage $1.7 trillion in assets. Such funds with a small number of investors are less diversified and may be of greater interest to the U.S. government for law enforcement, anti-corruption, or national security reasons.

As discussed below, the lack of AML and beneficial ownership requirements for advisers to private funds, concentrated foreign ownership, and weaknesses in SEC reporting and Committee on Foreign Investment in the United States (CFIUS) oversight compound to create significant challenges to the U.S. government's ability to monitor and review foreign investment through private funds.

Structural Problem, Structural Solution

Beyond any particular threat actor and policy concern of the moment, there is a longer-term structural flaw in the present arrangement. Today banks and broker-dealers are expected to profile their customers, understand their activity, monitor it for potentially suspicious activity, and report confirmed suspicious activity to FinCEN. The problem for large financial institutions in particular is that many of their largest, most complex, most important, and most sophisticated customers are private funds. The underlying limited partner investments in those funds may not be transparent to the covered financial institution with AML program obligations, and the actor with much more information – the adviser to that private fund – is presently exempt from AML program and reporting obligations. The adviser, not the bank or broker-dealer, should know the source of limited partner funds, the purpose of the investment, and the unusualness of any inbound or outbound wire instructions (for example, to an ostensibly unrelated party) representing subscriptions or redemptions.

The effect of this dynamic goes beyond beneficial ownership, customer due diligence, transaction monitoring, and suspicious activity report filing. Take 314(a) requests, the system through which FinCEN and U.S. and European Union law enforcement agencies request account and recent transaction information for persons or entities suspected of involvement in terrorism or money laundering. If a 314(a) suspect invests in a private fund using offshore money, the bank holding that private fund's account would not report the fund's account as a positive match on a 314(a) request. And the adviser who holds the "account" in which the suspect invests in the fund is not subject to 314(a). Today, FinCEN would receive a response of "no accounts linked to named suspect in the United States," which, in the above scenario, is in fact a false positive, and potentially a quite dangerous one.

Structural problems require structural solutions. Voluntary programs are not enough. Nine years ago, the Managed Funds Association representing the hedge fund industry recognized this, writing to FinCEN in support of the 2015 NPRM imposing a regulatory requirement, despite the industry best practice of maintaining a voluntary AML program.[14] That comment stood in stark contrast with the submission of the Private Equity Growth Capital Council, now known as the American Investment Council, which opposed the NPRM and asked FinCEN to exempt private equity from AML program requirements on the grounds that private equity funds typically require two-year lockups and that therefore any national security risk was eliminated due to this liquidity restriction.[15] The private equity association's argument that the risk is near zero is not only belied by basic logic – could an illicit actor not pay a lockup penalty? – and by the past nine years of documented illicit activity involving foreign adversaries routed through private funds. It also presents the problem in an exaggeratedly narrow frame, one derived from drug traffickers or other criminals needing to quickly wash cash proceeds derived from illegal activity. The hedge fund association, which represents an equally large segment of the private fund industry, saw the value of regulatory AML requirements and welcomed a race to the top, not the bottom.

The Proper Scope of Coverage of Advisers

FinCEN was wise to expand the scope of covered advisers as compared with the 2015 NPRM and proposed to include both RIAs to private funds and ERAs. ERAs are crucial because they capture two of the most important categories of advisers – venture capital firms and advisors to smaller funds. Venture capital firms are the most likely conduits for foreign actors to use to target early-stage critical technologies who are in the initial stages of development and not yet publicly traded. The focus of warnings from law enforcement and the Intelligence Community has been in this area, meaning venture capital is in many ways a higher priority than private equity and hedge funds, certainly from a national security perspective.

When it comes to more traditional money laundering, such as laundering criminal or corruption proceeds, smaller private equity and hedge fund firms are more likely to have weak or nonexistent AML programs under the current voluntary framework than the largest, established players. Therefore, it is imperative that FinCEN also cover advisers to such funds with less than $150 million in assets under management.

FinCEN should go farther than the NPRM in its final rule and add two other categories of covered institutions – family offices and real-estate focused funds.

Family offices are neither RIAs nor ERAs, as they are not subject to SEC oversight under the Investments Advisers Act of 1940.[16] While the SEC may have concluded reasonably that family offices do not pose a substantial investor protection risk because they are not allowed to solicit investments from the public and are limited to accepting the money of "family clients," the analysis for illicit finance risk is different. A family member under the SEC's family office rule includes anyone connected by a single common relative within ten generations of lineal descent.

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14 http://www.mfaalts.org/wp-content/uploads/2015/11/MFA-Comments-on-FinCEN-AML-Proposal.pdf.

15 https://www.investmentcouncil.org/wp-content/uploads/2015/11/2015-11-02-pegcc-comment-letter-re-proposed-aml-rules.pdf.

16 See 17 CFR § 275.202(a)(11)(G)–1, further elucidated at 76 FR 37983.

The definition also covers former spouses, certain non-profit entities, family companies, and certain "key employees" of the family office. Covering all private funds except family offices will create an obvious and inviting loophole for illicit money and state-directed campaigns targeting critical technology in particular. The only way to know the source of funds being invested by the family office, and the identity of the investors, is for FinCEN to ask.[17]

Most but not all real estate-focused pooled investment vehicles are not covered by the Investment Advisers Act for a different reason, which is that real estate held in fee simple ownership is not considered a "security" by the SEC. While the securities analysis may be relevant for the SEC, it should be irrelevant to FinCEN. Pooled real estate investment vehicles are structured similarly to private equity, hedge, or venture capital funds, with limited partners investing money into a partnership advised by general partners who manage or advise the fund. As in the case of family offices, pooled real estate investment vehicles can pose illicit finance risks, including money laundering, public corruption, and potential national security risks. A similar logic applies: covering all private funds except real estate funds will create an obvious and inviting loophole.

ACDC has recently completed a report on illicit finance risk in the commercial real estate sector, jointly authored with Global Financial Integrity and the FACT Coalition[18]. The report demonstrates that at least one of the most prominent recent public corruption or illicit finance cases involving commercial real estate investment utilized private real estate funds, including large-scale investment in U.S. real estate by a now sanctioned Russian billionaire.

Supervision of Covered Financial Institutions without a Federal Functional Regulator

FinCEN has wisely proposed to delegate examination of RIAs and ERAs to the SEC, which already has an examination office dedicated to private funds. However, the SEC does not examine family offices and many real estate funds. Absent a change in SEC regulations subjecting them to the Investment Advisers Act, it is unlikely to involve itself. Therefore, FinCEN should use the importance of this issue as an occasion to build out its in-house examination capacity.

ACDC made a similar point in its comment regarding FinCEN's real estate transparency proposal two years ago, as title insurers and escrow agents lack a federal functional regulator.[19] So too do money services businesses. As FinCEN continues to strengthen the country's AML regulatory architecture, the need to buttress the supervisory architecture will only become more apparent. FinCEN should therefore begin building a best-in-class in-house AML examination team, emulating the approach taken by many other AML conduct regulators around the world.

Beneficial Ownership – The Heart of the Matter

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[17] On this point, ACDC believes the Treasury Department's 2024 Investment Adviser Risk Assessment erred. It says (p.32), "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."

[18] http://acdatacollective.org/wp-content/uploads/2024/04/Money-Laundering-Risks-in-Commercial-Real-Estate-ACDC-GFI-FACT.pdf

[19] FINCEN-2021-0007-0153, https://www.regulations.gov/comment/FINCEN-2021-0007-0153.

ACDC does not object to FinCEN's plan to issue a rule establishing CIP requirements for investment advisers jointly with the SEC. Neither does it object to FinCEN's waiting to set out beneficial ownership requirements for advisers until the CDD Rule for banks has been aligned to the CTA. ACDC supports strengthening the CDD Rule for banks by incorporating concepts from the CTA, including broadening the definition of an ownership stake beyond simple equity holding to capture other forms of access to profit and removing the limitation to a single individual for reportable control persons. When FinCEN does promulgate beneficial ownership rules for private funds, though, it is imperative that the ownership stake be lower than 25%.

It is imperative that advisers to private funds be required to conduct their own determination of the beneficial owners of the limited partner investors, first and foremost because no one else is positioned to collect this information. In fact, the CDD Rule for banks and broker-dealers expressly exempts private funds managed by SEC-registered advisers from beneficial ownership reporting.[20] The beneficial ownership rule implementing the CTA similarly carves out private funds from obligations as reporting companies that must submit beneficial ownership information directly to FinCEN.[21]

The 25% ownership threshold, which is high even for operating companies, would be essentially useless for private funds. Pooled investment vehicles are designed to combine the assets of many investors and should, if behaving as expected, have more than four limited partners. Our analysis of the SEC data, described above, reveals that roughly 68% of all private funds (or 38,277 unique entities) are controlled by five or more beneficial owners. If the CDD rule is applied as currently written, many if not most of such funds would potentially not have to report the identities of any of their beneficial owners, since conceivably many of such limited partner investors would stay below the 25% threshold.[22] If advisers to private funds are not required in practice to identify the beneficial owners of all significant legal entity limited partner investors, the value of the due diligence, transaction monitoring, and suspicious activity reporting will be substantially limited. As discussed below, such a policy decision would also hamstring CFIUS.

The Need to Strengthen CFIUS and the SEC's Form PF Reporting

Although FinCEN is to be commended for its strong proposal to apply AML obligations to investment advisers to private funds, such action is necessary but not sufficient. In order for the risks posed by private funds to be addressed properly, especially with respect to the national security risk posed by foreign investments routed through such funds, both the SEC and CFIUS must also act to strengthen transparency of and oversight over private funds.

CFIUS today is reliant on a combination of press reporting, law enforcement and intelligence information, and voluntary and mandatory notifications as sources of information. These

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[20] 31 CFR § 1010.230(e)(2)(xi).

[21] 31 CFR § 1010.380(c)(2)(xviii).

[22] There will be many funds with five or more beneficial owners where one owner controls more than 25%. However, without stronger reporting requirements, it will be impossible for the SEC to verify the distribution of ownership, as the fund could plausibly claim that ownership was sufficiently dispersed so that all owners fell below the threshold.

reporting streams, along with the expansion of its oversight role and a larger staff, have allowed CFIUS to increase the number of transactions it reviews annually in the past several years. For example, in 2022 CFIUS reviewed 337 unique transactions generating 440 filings (declarations and notices).[23]

CFIUS should be reviewing even more foreign investments in sensitive sectors of the economy, but it does not for two reasons.

First, CFIUS is denied a critical source of information – positional data revealing equity stakes in non-public U.S. companies taken by U.S.-registered private funds managing foreign money. The SEC primarily collects information about private funds' holdings in publicly traded companies under Section 13 of the Exchange Act.[24] SEC reporting typically does not capture private funds' ownership of non-publicly traded companies, so CFIUS may not know where to look. The SEC should collect such information on Form PF[25] and make it available to CFIUS as lead information.

Even when CFIUS becomes aware of a private fund using foreign money to purchase a significant stake in a U.S. business operating in a sensitive sector, it often lacks the legal authority to review the investment. That is because of the investment fund safe harbor in the regulations governing non-controlling foreign investments (known as "covered investments," as opposed to controlling "covered transactions"). The safe harbor provision prevents CFIUS from reviewing a private fund investment in a U.S. business made with foreign money, as long as the foreign limited partners do not have formal decision-making rights or access to certain information.[26]

On paper, at least, CFIUS would not have the legal authority to review an investment in a company developing an emerging critical technology, even if 100% of the money came from a hostile foreign government, as long as the money was routed through a private fund managed by a U.S. adviser. This regulatory carve-out may unintentionally incentivize foreign actors seeking to access critical U.S. data or technology to route their investments through U.S. private funds in order to avoid CFIUS's jurisdiction and oversight.

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[23] https://home.treasury.gov/news/press-releases/jy1663 and https://www.gibsondunn.com/cfius-annual-report-for-cy-2022-top-takeaways/#:~:text=With%20a%20slight%20uptick%20in,154%20declarations%20(35%20percent).

[24] https://www.sec.gov/news/press-release/2023-219.

[25] https://www.sec.gov/news/press-release/2024-17 and https://www.sec.gov/files/formpf.pdf.

[26] 31 CFR 800.307.

Conclusion

ACDC applauds FinCEN's efforts to develop a strong AML regulatory framework around private funds. We would be pleased to discuss this important rulemaking process with you further and invite an ongoing dialogue with civil society. Please contact ACDC at team@acdatacollective.org.

Respectfully,

David Szakonyi, Director

Anti-Corruption Data Collective
A project of the Fund for Constitutional Government
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