TRANSPARENCY INTERNATIONAL
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PRIVATE INVESTMENT FUNDS ARE A HIGH RISK FOR MONEY LAUNDERING
ADVISERS SHOULD KNOW WHO'S INVESTING

SUMMARY

Investing involves placing money in a company or other asset for a return on that investment. But rarely do investors directly wire money to a company. Instead, they use intermediaries called "investment advisers."

According to a draft 2015 U.S. Treasury Department rule, "Investment advisers provide advisory services to many different types of clients, including individuals, institutions, pension plans, corporations, trusts, foundations, mutual funds, private funds, and other pooled investment vehicles."

There are almost 13,000 registered investment advisers in the United States, managing more than $80 trillion in assets. This number reflects the number of SEC registered advisers, which includes those who manage $100 million or more in assets. It does not, however, include advisers managing less than the $100 million threshold, who are not required to register with the SEC.

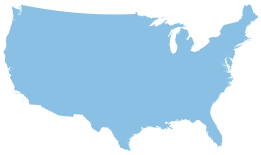
SUBSTANTIAL RISK IN THE MARKET

U.S. commercial banks now hold approximately $17 trillion in deposits. Recognizing the inherent risks in the commercial banking sector, Congress adopted anti-money laundering rules in the Bank Secrecy Act that date back to the 1970s. Additional safeguards were put in place in the wake of the September 11 attacks.

Private investment firms have fewer safeguards than traditional banks—despite having a financial portfolio that will soon be an equivalent size. This lack of customer due diligence ("CDD") rules (aka know your customer or KYC rules) prompted the FBI to note in a May 2020 report on private equity firms that "threat actors exploit this vulnerability to integrate illicit proceeds into the licit global financial system."

The FBI's report cited examples as varied as cybercrime, sanctions evasion, and drug smuggling, including:

A New York-based private equity firm "received more than **$100 million** in wire transfers from an identified Russia-based company allegedly associated with Russian organized crime."



A U.S.-based law firm allegedly assisted with secretly moving **$400 million** in a fraudulent cyber currency scheme "through a series of purported private equity funds holding accounts at financial institutions, including those in the Cayman Islands."

In Los Angeles, a Mexican drug cartel "recruited and paid individuals to open hedge fund accounts at private banking institutions."

A London- and New York-based hedge fund proposed "using a series of shell corporations to purchase and sell prohibited items from sanctioned countries to the United States."

SAFEGUARDS FOR INVESTMENT ADVISERS DON'T COMPARE WITH BROKER DEALERS OR COMMERCIAL BANKS

Currently, commercial banks have CDD requirements that include identifying the beneficial owners of companies that open accounts, initiating investigations into those owners to identify money laundering risk, filing suspicious activity reports with Treasury's Financial Crimes Enforcement Network (FinCEN) when sufficient risk is identified, and monitoring accounts with a higher risk profile on an ongoing basis. Banks can and have been fined for failing to meet their anti-money laundering responsibilities.

Investment brokers, those who assist firms with identifying investors, also have KYC obligations. Not all investment advisers use registered brokers and, therefore, can escape the most basic anti-money laundering checks.

Instead, investment advisers themselves are only required to ensure that they take on certain types of investors called "qualified purchasers" or "accredited investors." These requirements call for the adviser to ensure the investor can afford the investment and the investment risk—but they are not required to engage in due diligence to guard against money laundering, terrorist financing, corruption financing, or other criminal activity. Ensuring investors can afford the risk is a laudable goal, but it is not a substitute for protecting against corrupt and criminal actors accessing our financial system. A corrupt official seeking to launder stolen money using an offshore company would be able to invest that money easily through a U.S. investment adviser today, and that must change.

UPDATE AND FINALIZE THE DRAFT CDD RULE FOR INVESTMENT ADVISERS

FinCEN should issue new rules that require investment advisers to engage in customer due diligence for prospective investors. A rule for investment advisers would level the playing field across all investment vehicles. KYC requirements for investment brokers prove these checks can be done in the sector. The rules should require all investment advisers to know their customers, including by requiring the identification of the beneficial owners of companies that open accounts, initial investigations into those owners to identify money laundering risk, the filing of suspicious activity reports with FinCEN when sufficient risk is identified, and the ongoing monitoring of accounts with a higher risk profile.

The rules should cover the full range of advisers to avoid loopholes that allow for exploitation by bad actors. The rules should cover:

1. Advisers currently registered with the SEC
2. Advisers with less than $100 million of assets under management
3. Advisers working solely with venture capital funds
4. Advisers working solely with rural business funds
5. Advisers working solely with family funds

FinCEN already has the authority to require financial institutions to keep records and file reports that have a "high degree of usefulness in criminal, tax, or regulatory investigations or proceedings, or in the conduct of intelligence or counterintelligence activities, including analysis, to protect against international terrorism." The Treasury Secretary is further authorized to include "additional types of businesses within the [Bank Secrecy Act] definition of financial institution if the Secretary determines that they engage in any activity similar to, related to, or a substitute for, any of the listed businesses."

In 2015, a CDD rule for certain investment advisers was proposed by FinCEN. This rule should be updated so that it reflects the continuously developing private investment fund market, and then quickly finalized.

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For more information, please contact Scott Greytak, Director of Advocacy for Transparency International's U.S. Office, at sgreytak@transparency.org.