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SRZ Partner Addresses FBI Bulletin on Money Laundering by Private Funds

SRZ Private Funds Regulatory Update

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A leaked FBI intelligence bulletin warns that criminals and foreign adversaries may be using hedge funds and private equity funds to launder money, but reported instances of money laundering through private funds are rare. In an article published by Morning Consult and reprinted below, SRZ partner Gary Stein discusses the reasons why the FBI's concerns may be overstated and the efforts by the private fund industry to prevent money laundering.

Leaked FBI Bulletin on Private Funds Misses the Mark

By Gary Stein

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Criminals, drug cartels and corrupt foreign officials are notoriously creative when it comes to laundering their ill-gotten gains. Financial service firms must stand vigilant against this kind of illicit activity. As a lawyer who counsels hedge funds and private equity funds on their anti-money laundering programs, I have found that the private fund industry takes this responsibility seriously.

Unfortunately, a recently leaked Federal Bureau of Investigation intelligence bulletin displays a profound misunderstanding of the limited money laundering risks posed by private investment funds. The bulletin

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warns that criminals and foreign adversaries “likely” are using hedge funds and private equity funds to launder money. But reported instances of money laundering through private funds are quite rare. The Federal Bureau of Investigation (“FBI”) bulletin itself identifies only one individual convicted for such activity — and he was a corrupt lawyer who launched fraudulent funds to launder dirty money from his clients.

Professionally run private funds are not attractive vehicles for money laundering. Liquidity is limited, including lengthy “lock-up” periods that can prevent investors from withdrawing their capital for years. Investors cannot transact with third parties, and distributions and redemptions must be paid to the investor’s own account. Given these structural characteristics, it is not surprising that the majority of fund assets come from long-term institutional investors such as public pension plans, private pension plans, endowments and foundations.

The FBI bulletin nonetheless claims that private funds are especially vulnerable to money laundering for three primary reasons. Each is based on a flawed understanding of how private funds work, how they are regulated and the industry’s longstanding commitment to AML compliance.

First, the FBI’s bulletin claims private funds enable investors to “circumvent” traditional AML regulations. This is simply not the case. As a rule, private funds do not accept cash deposits from investors — the investor’s funds must come from an existing account at a bank or other financial institution subject to AML regulations. Before opening that account, the investor will have had to satisfy the financial institution’s AML program, including identification and verification of its beneficial owners. Then, the investor will be subject to the private fund’s own AML screening. It therefore would be illogical for criminals looking to avoid AML scrutiny to opt to place their money with a private fund.

Second, the FBI bulletin asserts that private funds are “largely exempt” from regulatory oversight. This, too, is incorrect. Since 2012, under the Dodd-Frank Act, the vast majority of U.S. private fund managers have been registered with the Securities and Exchange Commission or a state securities regulator. The U.S. Securities and Exchange Commission (“SEC”) and state regulators actively regulate private fund managers, even conducting on-site examinations. According to the SEC, there are at least 13,475 registered investment advisors, with assets under management of $84 trillion.

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Third, the FBI bulletin incorrectly assumes that AML programs are not adequately designed to monitor and detect money laundering through private funds. In fact, private fund managers typically maintain robust AML programs that are modeled after those of other financial institutions. They do so because they are subject to federal criminal money-laundering statutes and because their counterparties — including brokers, lenders and co-investors — require fund managers to demonstrate that they have implemented effective AML programs. The SEC has for years allowed brokers to rely on fund managers' AML programs.

These AML programs typically include, among other things, written AML policies and procedures; "know your investor" requirements; screening for negative public information about the investor; enhanced due diligence for higher-risk investors; stringent restrictions on transfers to third parties and AML training of relevant fund employees. The programs are implemented by internal compliance personnel and, often, by third-party administrators staffed by AML professionals.

It's true that private funds are not required by current law to have AML programs. That is not because of opposition from the industry. In 2015, FinCEN, the arm of the U.S. Treasury Department chiefly responsible for combating money laundering, proposed an AML program rule for fund advisors. Industry groups like the Managed Funds Association actively supported FinCEN's proposal, which was consistent with what fund managers are already doing in practice. Five years later, the proposed rule still has not been finalized. This strongly suggests that FinCEN does not share the FBI's assessment that private funds are a substantial source of money laundering risk.

The FBI's efforts to identify weaknesses in the U.S. financial system that facilitate money laundering are commendable. However, any such assessment should be based on a proper understanding of how the private fund industry actively works to prevent money laundering.

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