



PRIVATE INVESTMENTS, PUBLIC HARM

**How the Opacity of the Massive U.S. Private
Investment Industry Fuels Corruption and
Threatens National Security**

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The Financial Accountability and Corporate Transparency (FACT) Coalition is a non-partisan alliance of more than 100 state, national, and international organizations working toward a fair tax system that addresses the challenges of a global economy and promoting policies to combat the harmful impacts of corrupt financial practices.

Global Financial Integrity

Global Financial Integrity (GFI) is a Washington, D.C.-based think tank focused on illicit financial flows, corruption, illicit trade and money laundering. Through high-caliber analyses, fact-based advocacy to promote beneficial ownership and a cloud-based database to curtail trade fraud, GFI aims to address the harms inflicted by trade misinvoicing, transnational crime, tax evasion and kleptocracy. By working with partners to increase transparency in the global financial system and promote Trade Integrity, GFI seeks to create a safer and more equitable world.

Transparency International U.S. Office

Transparency International is a global movement with one vision: a world in which government, business, civil society and the daily lives of people are free of corruption. With more than 100 chapters worldwide and an international secretariat in Berlin, we are leading the fight against corruption to turn this vision into reality. The U.S. office focuses on stemming the harms caused by illicit finance, strengthening political integrity, and promoting a positive U.S. role in global anti-corruption initiatives. Through a combination of research, advocacy, and policy, we engage with stakeholders to increase public understanding of corruption and hold institutions and individuals accountable.

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ABBREVIATED KEY TERMS

AML/CFT	Anti-Money Laundering/Combating the Financing of Terrorism
BSA	Bank Secrecy Act
CDD	Customer Due Diligence
CTA	Corporate Transparency Act
FATF	Financial Action Task Force
FinCEN	Financial Crimes Enforcement Network
KYC	Know Your Customer
SAR	Suspicious Activity Report
SEC	Securities and Exchange Commission
VCF	Venture Capital Firm

EXECUTIVE SUMMARY

A growing body of evidence suggests that this gap – the absence of requirements that investment funds and investment advisers establish anti-money laundering programs and conduct reviews to understand with whom they are doing business – is a significant vulnerability that negatively impacts U.S. national security and the lives of ordinary Americans.

The Pandora Papers exposé again reveals how financial secrecy in the United States has made the country a favored destination for the world's elite to hide illicit funds. The U.S. private investment industry, unfortunately, offers a perfect confluence of factors that make it an ideal place to hide and launder the proceeds of corrupt and criminal activity.

- + **It is large.** The U.S. market alone holds more than US\$11 trillion dollars in assets.
- + **It is opaque.** Private funds, which target high-net worth investors, do not have the same reporting requirements as public equity and retail funds marketed for ordinary investors.
- + **It is complex.** In the United States, there are nearly 13,000 investment advisers with little to no anti-money laundering due diligence responsibilities.

The U.S. has adopted and implemented a series of rules to detect and prevent illicit funds from entering its financial system. The Bank Secrecy Act (BSA), passed in 1970, established an anti-money laundering

(AML) framework. Subsequent legislative updates and regulations built out a risk-based approach to AML reporting in the U.S. across 25 types of financial institutions ranging from banks, broker-dealers, mutual funds, credit unions, casinos, pawn shops, and others. The expansion of the U.S. rules largely follow international standards. Two notable exceptions are 1) the lack of regulation of investment advisers – that is, individuals or firms in the compensated business of providing advice about investing in securities; and 2) unregistered investment companies such as hedge funds, private equity, venture capital funds, and real estate investment trusts, and family offices.

A growing body of evidence suggests that this gap – the absence of requirements that investment funds and investment advisers establish anti-money laundering programs and conduct reviews to understand with whom they are doing business – is a significant vulnerability that negatively impacts U.S. national security and the lives of ordinary Americans.

As detailed in this report, a few examples demonstrate the risks:

- + Russian and Chinese interests have sought access to sensitive U.S. technology and innovation through private investment vehicles.
- + A cryptocurrency scheme run through private equity was among the largest financial scams in history.
- + A lack of disclosure in private equity obscured the majority stake owned by a Russian oligarch in a U.S. voting management firm active in Maryland, calling into question election security.
- + A leaked FBI intelligence bulletin included examples of illicit financial schemes using pooled investment vehicles involving Mexican drug cartels, Russian organized crime, and U.S. sanctioned countries.

In 2002, 2003, and 2015, the U.S. Treasury Department proposed rules to close the gap and require the private investment industry to perform due diligence on potential investors. Unfortunately, the proposed rules were never

finalized and the vulnerability in our financial system remains.

The FACT Coalition, Global Financial Integrity, and the Transparency International U.S. Office recommend that the U.S. Treasury Department update and finalize an AML rule covering both investment advisers and investment companies to address significant threats to America's financial system, national security, and citizens.

The rule should require (1) establishing a risk-based anti-money laundering and counter terrorist financing (AML/CFT) program; (2) identification of the real, "beneficial" owners of legal entities that open accounts; (3) assessments of those owners and their transactions to identify money laundering risk; (4) the filing of suspicious activity reports with the Financial Crimes Enforcement Network (FinCEN) when sufficient risk is identified; and (5) the ongoing monitoring of accounts with a higher risk profile.

A strong rule that would bolster national security and mitigate threats to America's financial system should cover the full range of unregistered investment companies and

investment advisers, to avoid inadvertently creating loopholes ripe for exploitation. FinCEN should design the rule to institute affirmative anti-money laundering obligations for the following categories of advisers:

1. Advisers currently registered with the U.S. Securities and Exchange Commission (SEC);
2. Advisers working solely with hedge funds, private equity, venture capital funds, rural business investment companies, family offices, or any other type of private fund; and
3. Advisers working as foreign private advisers.

The Biden administration has rightfully designated the fight against corruption as a national security priority and as a core pillar of the forthcoming Summit for Democracy. Committing to finalize a rule on unregistered investment companies and the full range of investment advisers would provide critical safeguards to close money laundering loopholes and protect the integrity of the U.S. and global financial systems.

INTRODUCTION

As the world's largest economy, the United States is a prime target for financial investment using legitimate and illegitimate resources alike. A recent paper by Global Financial Integrity found the following: The amount of illicit non-tax evading money generated and laundered annually in the U.S. is estimated at \$300 billion. When money laundered from tax evasion, coupled with illicit funds that enter the U.S. financial system from outside the country are added, that figure could approach as much as \$1 trillion.¹



In recent years, significant attention has been generated on the use of anonymous companies, art, antiquities, and trade-based money laundering to facilitate illicit money in and out of the United States. The attention and advocacy around these issues culminated in the passage of the Corporate Transparency Act (CTA) in 2021. This landmark law requires the creation of a beneficial ownership directory and an AML/CFT rule for antiquities dealers alongside a requirement that the Treasury Department undertake studies into the risks of money laundering through art and trade-based money laundering. One area of risk that has been conspicuously absent in all of these efforts to strengthen the U.S. financial system against abuse are measures to create accountability within the U.S. private investment industry including hedge funds, private equity, venture capital firms, and family offices.

These vulnerabilities in the U.S. financial system from the private investment sector are far from hypothetical and encompass more than one-off examples. In July 2020, a leaked FBI intelligence bulletin revealed that the FBI believed with “high-confidence” that the US\$11 trillion private investment fund industry was being used to launder money.² The assessment concluded that hedge funds, private equity funds, and other types of private placements of funds were being utilized to move illicit proceeds,³ and referred back to a 2019 FBI report where it likewise concluded criminal actors were “very likely” to launder proceeds from fraud schemes through “fraudulent hedge funds and private equity firms.”⁴

So why are criminal and corrupt actors turning to private investment vehicles to legitimize their illicit funds? Choosing how to obscure one’s illicit funds involves a number of factors,

including, but not limited to, the opacity of transactions and the size of the market. The private investment sector in the United States, unfortunately, offers a perfect confluence of favorable factors that make it an ideal place to hide and launder the proceeds of corrupt and criminal activity.

One area of risk that has been conspicuously absent in all of these efforts to strengthen the U.S. financial system against abuse are measures to create accountability within the U.S. private investment industry including hedge funds, private equity, venture capital firms, and family offices.



First, the U.S. private investment market is opaque. While retail trading platforms have several public reporting requirements, private investments have almost none. U.S. securities laws require private equity firms to ensure that the clients they accept are “qualified purchasers” or “accredited investors,”

but do not require them to disclose – to the public or the government – the identity of those clients. While investment firms must ensure their clients have an ability to weather a loss and assume investment risk, they currently do not have to screen the clients’ funds or business activities to avoid investing illicit funds. In addition, accredited

investors can be either natural persons or legal entities⁵, which can further add to the opacity of an investor’s identity.

Furthermore, public investment funds almost always employ registered investment brokers to identify clients and execute trades on the clients’ behalf. These brokers are required by law to know with whom they are doing business, as they have what is called “know your customer” (KYC) due diligence responsibilities.⁶ That means that U.S. brokers have an obligation to check that any prospective client, either an individual or an entity, is not attempting to move dirty money into the U.S. financial system. In contrast, private investment vehicles do not always use registered brokers with AML obligations. While no U.S. business is allowed to directly engage with anyone on an official U.S. sanctions list, unlike some other financial service providers – banks for instance – private



What does an investment adviser do?

An investment adviser is a firm or individual that offers guidance on, or otherwise manages, the investment decisions of their clients.

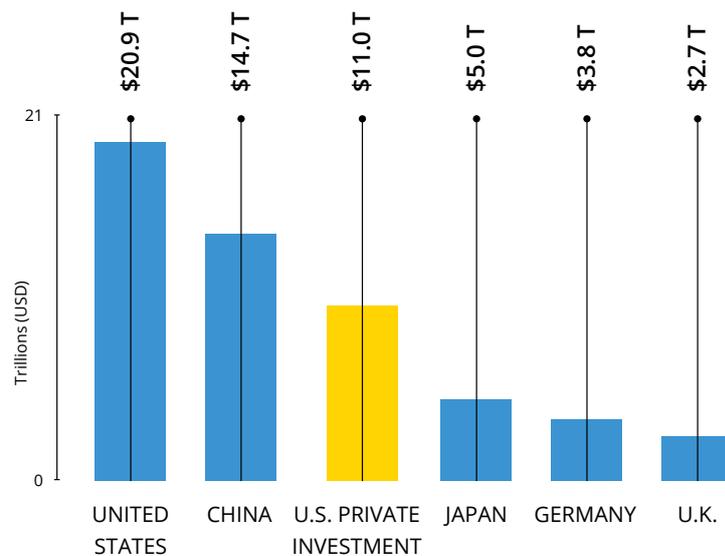
While an investment adviser may direct decisions about clients’ portfolios with their consent, the adviser may or may not personally execute the purchase, sale, or trade on behalf of their client. They sometimes work through a third-party broker-dealer to get the job done.

It is other instances, in which the investment adviser operates independently outside the scope of anti-money laundering safeguards, that pose the most risk.

GDPs FOR 2020

Private equity, hedge funds, and venture capital had approximately US\$11 trillion in assets in 2020, and the private investment market is growing rapidly.

● U.S. private investment market would be 3rd largest economy in the world.



*Source: https://data.worldbank.org/indicator/NY.GDP.MKTP.CD?most_recent_value_desc=true

investment vehicles are not required to perform even a basic check to determine if an agent or entity requesting services is actually a front for a corrupt or criminal actor. Nor are they required to report suspicious activity to authorities, limiting law enforcement's ability to detect or prevent illicit transactions.

Second, the U.S. private investment sector is very large. Overall, the total equity market – public and private investments – in the United States is larger than the economy itself. With more than US\$59 trillion in assets under management, the U.S. market is at least

four times the size of the next largest market.⁷ While private investment makes up only a portion of the total market, it is still a very large market by any metric. Private equity, hedge funds, and venture capital had approximately US\$11 trillion in assets in 2020, and the private investment market is growing rapidly.⁸ Investments in private equity have “grown more than sevenfold since 2002, twice as fast as global public equity.”⁹ Venture capital firms, a form of private equity, grew by 13 percent per year in that same period including in 2018, which ranked as the third biggest year for raising capital on record.¹⁰

Experts project private equity will double its current portfolios to US\$9 trillion by 2025, and hedge funds will grow to a little more than US\$4 trillion.¹¹ The U.S. commercial banks, which do have KYC responsibilities, now hold approximately US\$22.5 trillion in deposits.¹² The private investment market is quickly growing to an equivalent size.

Finally, while there are almost 5,000 commercial banks in the United States, all with KYC obligations, almost 13,000 hedge funds, private equity, venture capital firms, and family offices are operational without similar requirements.¹³

MONEY LAUNDERING IN A PRIVATE INVESTMENT TRANSACTION



Mr. Bad is a corrupt official who stole millions and is sanctioned by the U.S. government.



SCENARIO 1: U.S. BANK



Mr. Bad takes his stolen money to a U.S. bank. The bank does a “know your customer” check and turns him down.



SCENARIO 2: ANONYMOUS COMPANY



Mr. Bad creates an anonymous company and moves his stolen money into the company. The company goes to a U.S. bank. The bank does a “know your customer” check and turns him down.



SCENARIO 3: OFFSHORE



Mr. Bad registers his anonymous company offshore and tries to invest the money through a U.S. investment broker in public funds. The broker does a “know you customer” check and turns him down.



PRIVATE INVESTMENT TRANSACTION



Mr. Bad’s anonymous company uses the offshore account to invest with an investment adviser in private funds, who may only check to see if there are enough funds in the account. Then, they can legally say yes, let’s do business!



The Biden administration's expansive anti-corruption platform has created an environment ripe for action to close gaps in the U.S. AML framework. In its June 2021 national security study memorandum, the White House elevated anti-corruption as a core national security interest, calling corruption a threat to "United States national security, economic equity, global anti-poverty and development efforts, and democracy itself" and proposing, as a solution, U.S. policies around "effectively preventing and countering corruption and demonstrating the advantages of transparent and accountable

governance."¹⁴ A senior White House official explained, "we're looking to make significant systemic changes to the regulatory structure that governs illicit finance."¹⁵ Safeguarding the U.S. investment market from abuse by corrupt regimes, U.S. adversaries, and criminals helps protect Americans and American national security interests while aiding U.S. partners in low- and middle-income countries to combat illicit financial flows that undermine good governance and rob them of much-needed resources.

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MAPPING THE PROBLEM



Assessing Demand for Financial Secrecy Instruments with Long-Term Horizons

The first mention of a money laundering operation often conjures up the mental image of a seedy, all-cash business on the edge of town. Yet methodologies to launder illicit financial flows are plentiful, and many have kept pace with a modern, globalized economy. The benefits to the criminal and corrupt are two-fold: they discover increasingly sophisticated ways to evade law enforcement by diversifying their holdings, while they simultaneously maximize returns on ill-gotten gains.

Established criminal networks like Italy's 'Ndrangheta mafia have shown the necessary patience to leverage financial markets for their fraudulent schemes. For instance, between 2015 and 2019, the powerful mafia organization reportedly

attracted approximately US\$1.6 billion in legitimate international investment – from hedge funds, family offices, pension funds, and other market participants, including one of Europe's largest private banks – by selling private bonds backed by front companies embedded in Italy's health sector.¹⁶ The assets were reportedly sold through an instrument created by CFE, a Swiss investment bank, which claimed no knowledge of the criminal nature of the assets.¹⁷

Likewise, foreign corruption presents a threat to the integrity of U.S. investment channels. Many authoritarians have investment horizons that match their decades-long rule. As such, they engage in the equivalent of illicit estate planning: to consolidate power in-country, to keep their wealth out of reach of political opponents by moving it to rule-of-law jurisdictions, and ultimately, to pass on their wealth to their children.

The benefits to the criminal and corrupt are two-fold: they discover increasingly sophisticated ways to evade law enforcement by diversifying their holdings, while they simultaneously maximize returns on ill-gotten gains.



The dictatorial demand for long-term investments moves money through a multitude of financial vehicles. For instance, look to real estate. Teodoro Obiang – president of oil-rich Equatorial Guinea and one of the world’s longest serving dictators – has depleted the country’s coffers and made Equatorial Guinea one of Africa’s lowest per-capita income countries.¹⁸ He has reportedly used the stolen wealth to cement his financial and political dominance, make extravagant purchases abroad (including a US\$2.6 million mansion a few miles from the U.S. Capitol), and tee up rule for his sons.¹⁹ According to a settlement with the Department of Justice, Teodorin Obiang, one of two sons and the current vice president, reportedly used shell companies as conduits for embezzled money to buy real estate in Malibu, California, Michael Jackson memorabilia, and a US\$35 million Gulfstream jet.^{20,21}

Trusts offer another investment vehicle. Ferdinand Marcos ruled the Philippines as president for 21 years, and during that time, was believed to have stolen US\$10 billion while in office.²² Yet, during this 20-year period, his official annual salary never rose above US\$13,500.²³ Though many of the Marcos family accounts were frozen after his government finally fell in the 1980s, hundreds of millions of dollars remained unrecovered. Two decades later, a whistleblower stated that “lawyers for KPMG (then known as Fides, a subsidiary of Credit Suisse) moved the \$400 million in Marcos funds to a Liechtenstein trust, Limag Management und Verwaltungs AG” where, left to accrue interest in the intervening years, its value was estimated to have doubled.²⁴ KPMG has denied the whistleblower’s accusations. The availability, secrecy, and long investment horizon of a trust provide parallels to the operation of many U.S. private investment funds.

For both the criminal and the corrupt, money laundering is not just about short-term gains.

Other powerful figures in jurisdictions plagued by corruption likewise turn to long-term investments, including by recruiting family offices and other gatekeepers to manage their wealth. Jahangir Hajiyeu, former chair of the biggest bank in Azerbaijan, earned a salary of US\$70,650 in 2008.²⁵ Yet Jahangir and his wife Zamira – who, according to Bloomberg, “earned no significant income herself” – spent millions of dollars in the UK purchasing a US\$14.3 million townhouse in London and a Gulfstream jet for US\$42.5 million.²⁶ Zamira, in a week alone, reportedly spent nearly a million dollars at the Harrods department store in London.²⁷ According to a National Crime Agency investigation, the couple was allegedly able to hide and spend all this money through the assistance of a network of gatekeepers including the global trust administration firm Trident Trust, which has operations in the U.S., and a multi-family office Werner Capital, based in London, that helped set up entities to hold the couple’s various assets.²⁸ It’s unclear what questions either firm asked the couple about the source of their wealth when taking them on as clients.²⁹

Perhaps surprisingly, even these traditionally long-term horizon investments are not safe from short-term exploitation for the purposes of financial secrecy. There is no better example than the 1MDB scandal, a global case of corruption in which private

equity played a prominent role in the theft of billions from the country’s development fund by the former Prime Minister of Malaysia.³⁰ A 2016 U.S. Department of Justice civil forfeiture complaint regarding the 1MDB scandal claimed that hundreds of millions of dollars from the development fund meant for a bond offering were layered through private investment funds and then pocketed by the perpetrators of the fraud. In one such example, over the course of one week in May 2013, an arm of the development bank, 1MDB Global, purportedly transferred a total of US\$1.59 billion from its Swiss bank account to accounts belonging to three different overseas investment funds in the British Virgin Islands and in Curaçao.³¹ The funds were passed back and forth through multiple accounts held in the names of different legal entities but all with the same beneficial owner. In a related case, it was determined that the crisscross movement of funds had no legitimate commercial purpose and was designed to “obscure the nature, source, location, ownership and/or control of the funds.”³² Clearly, private investment funds are ripe for exploitation, including as short-term and long-term investment vehicles used to disguise and conceal the origin of illicit funds.

The 1MDB case, in particular, illustrates an additional point: the lack of AML programs and

disclosure requirements in the U.S. private investment industry heighten risks among advisers and companies located in the United States as well as among advisers located outside the U.S. seeking to access U.S. markets. Non-U.S. advisers are bound to view the U.S. financial sector as an attractive avenue to hide illicit funds, given the lack of AML controls and opacity of the U.S. private investment industry. Increasing the risk to the U.S. financial system is the low level of AML enforcement activity outside of the United States, whether due to limited resources, a weak regulatory climate, or a lack of political will to tackle money laundering. These non-U.S. deficiencies can be exploited to create added opacity around the identity of non-U.S. individuals and entities seeking to exploit the U.S. financial system.

For both the criminal and the corrupt, money laundering is not just about short-term gains. As the above examples from across the globe illustrate, criminals and kleptocrats are, in fact, interested in financial instruments with a longer horizon, an acceptable return on investment, and the ability to diversify their holdings and conceal their money-laundering tactics. For those with the means, the long horizon, high yield, and opacity of multi-year investments like those offered by hedge funds, private equity, and venture capital firms make them attractive conduits for money laundering.

UNDERSTANDING THE CURRENT FRAMEWORK

The U.S. anti-money laundering regime – enshrined in Bank Secrecy Act (BSA) regulations – has built out a risk-based approach to AML reporting across 25 types of financial institutions including banks, mutual funds, credit unions, casinos, pawn shops, and others.³³ The list includes broker-dealers who, like investment advisers, can execute trades in securities on behalf of clients.

FinCEN's CDD rule was an important step toward meeting international standards, but it failed to include a strong definition of beneficial owner, and it failed to encompass all of the entities specified in FATF's definition of "financial institution," such as private investment funds.

Unlike broker-dealers, however, investment advisers are not currently required to maintain anti-money laundering/combating the financing of terrorism (AML/CFT) programs under the BSA. Nor are several types of "investment companies," which are explicitly exempted from that requirement.³⁴ While FinCEN has made multiple attempts to create anti-money laundering obligations for investment advisers and certain investment companies, the U.S. has failed to finish the work and so remains an outlier as the United Kingdom and other countries with similar financial systems in the European Union have applied their anti-money laundering requirements to the private investment sector.

This section examines U.S. efforts at strengthening customer due diligence (CDD) requirements for financial institutions, previous

attempts at creating AML/CFT requirements for investment advisers and investment companies, and current regulatory practice among U.S. allies.

Current U.S. Customer Due Diligence Obligations for Financial Institutions Exclude Private Investment Companies and Investment Advisers

The BSA has been regularly amended over the course of its 50-year history to meet modern challenges. The Financial Action Task Force (FATF), the international standard-setting organization for anti-money laundering and combating terrorist financing, described the U.S. framework in its most recent evaluation in 2016 as "well-developed," coordinated across government agencies, and rooted



in a sophisticated understanding of money laundering and terror financing risks.³⁵

Yet the same 2016 FATF evaluation highlighted a major U.S. deficit. The deficit was that, in the United States, law enforcement and other essential parties had no way of learning the identity of the true, “beneficial” owner of legal entities formed in the 50 U.S. states. In January 2021, Congress took an important step towards curing that deficit by enacting the Corporate Transparency Act, which will, when implemented, require corporations, limited liability companies, and other similar entities to report their beneficial owners to a secure database at FinCEN.

A related problem was that, although as of 2001 the BSA required financial institutions to establish AML programs,

BSA regulations did not initially spell out requirements for financial institutions – as part of their obligation to know their customers – to identify the beneficial owners of legal entities like shell corporations and trusts that opened accounts with them. That regulatory gap left the legal door open for financial institutions to administer accounts for entities with hidden owners.

In 2016, the Treasury Department finalized new regulations requiring certain financial institutions – banks, credit unions, mutual funds, brokers-dealers in securities, futures commission merchants, and introducing brokers in commodities – to conduct customer due diligence reviews and collect beneficial ownership data for account holders that were legal entities.³⁶ FinCEN’s CDD rule was an important step toward meeting

international standards, but it failed to include a strong definition of beneficial owner, and it failed to encompass all of the entities specified in FATF’s definition of “financial institution,” such as private investment funds.^{37, 38}

Historical Efforts to Create AML/CFT Obligations for Investment Companies and Advisers

Over the past twenty years, the U.S. government has initiated at least three efforts to bring the private investment industry further under the purview of BSA regulations. In 2001, following the 9/11 terrorist attack, Congress enacted new anti-money laundering laws that, among other provisions, required all financial institutions subject to the Bank Secrecy Act to establish anti-money laundering programs.³⁹

A few months later in 2002, however, the Treasury Department granted “temporary exemptions” for several categories of financial institutions, including “investment companies.”⁴⁰ That same year, FinCEN required certain investment companies registered with the SEC, including mutual funds, to establish AML programs,⁴¹ but did not otherwise alter the “temporary exemption.”

On September 26, 2002, FinCEN for the first time proposed a rule that would require unregistered investment companies, including hedge funds, private equity, commodity pools, and real estate investment trusts, to establish AML/CFT programs.⁴² The following year,

on May 5, 2003, FinCEN proposed another rule that would require “investment advisers” registered with the SEC to establish AML/CFT programs and also delegate FinCEN’s authority to conduct compliance examinations of those entities to the SEC.⁴³

Exactly how the 2003 proposed regulation of registered “investment advisers” related to the 2002 proposed regulation of unregistered “investment companies” was not explicitly addressed. After years of inaction finalizing either rule, however, on November 4, 2008, FinCEN withdrew both.⁴⁴

In 2015, toward the end of the Obama administration, FinCEN once again proposed a rulemaking for registered investment advisers.

According to the draft rule, the proposed changes would bring both registered investment advisers and some unregistered investment companies under the purview of the BSA.⁴⁵ In its proposal, FinCEN stated that “money laundering involves three stages, known as placement, layering, and integration, and an investment adviser’s operations are vulnerable at each stage.”⁴⁶ The 2015 rule proposed requiring a certain class of registered investment advisers – meaning those with more than US\$100 million in assets under management and not subject to several exemptions – to establish AML programs, begin submitting Suspicious Activity Reports (SARs) to law enforcement, and establish certain recordkeeping and reporting practices.⁴⁷



Why should investment advisers conduct CDD if other financial institutions are already reporting?

BSA-covered financial institutions like banks are required to conduct CDD for their direct clients, including investment advisers opening bank accounts. But they are not required to go farther and conduct CDD reviews of their client’s clients. Instead, BSA-covered institutions like banks are allowed to rely on their direct clients, including investment advisers, to conduct reviews of their own clientele. That arrangement breaks down, however, when investment advisers have no affirmative legal obligation to conduct CDD reviews of their clients and no idea who is the true owner of a legal entity client.



FinCEN also proposed once again delegating its examination authority to the SEC.⁴⁸ FinCEN's 2015 proposed rule outlined AML/CFT requirements for investment advisers that were similar to those already applicable to broker-dealers and mutual funds.⁴⁹ FinCEN warned that, **"As long as investment advisers are not subject to AML program and suspicious activity reporting requirements, money launderers may see them as a low-risk way to enter the U.S. financial system."**⁵⁰

Despite support from civil society and financial industry associations,⁵¹ the 2015 rule apparently lost "inertia among federal bureaucracies" and was never finalized.⁵²

The European Union and UK Impose AML Requirements on Investment Funds

The failure to impose affirmative AML obligations on the private investment industry relegates the United States to a place in line behind many of its allies. For example, six years ago in 2015, the European Union passed the 4th Anti-Money Laundering Directive (4th AMLD),⁵³ which includes investment firms within its definition of "financial institution" and therefore renders investment advisers subject to the same CDD standards as banks and other reporting entities. In 2017, the UK passed

provisions based on the 4th AMLD and imposed AML obligations on investment advisers as well as "enabler" professions such as real estate agents and incorporation agents.⁵⁴ Making similar changes in the United States would bring the U.S. in alignment with its allies and with international AML standards it has long pledged to meet.

CASE STUDIES

This section presents 11 case studies illustrating how the absence of U.S. AML obligations on investment companies and investment advisers has increased U.S. vulnerability to criminal activity, corruption, and national security threats.

The evidence base establishing money laundering through private funds, including hedge funds, private equity, venture capital funds, and family office investment activities is substantial. Throughout the course of our research, we identified multiple mechanisms through which money laundering risk was introduced. The cases presented in this report broadly represent three trends:

- + **First**, cases in which investment advisers or investment companies fail to heed red flags in operating with specific clients;
- + **Second**, cases in which the opacity resulting from a lack of government disclosure

requirements for private investment funds increased the difficulty of banks and other institutions to conduct their own AML and due diligence processes; and

- + **Third**, cases demonstrating the highest level of wrongdoing, in which threat actors and criminals deliberately exploited the opacity of private investment funds to dodge detection by law enforcement.

A rule requiring investment advisers and investment companies to adopt risk-based anti-money laundering programs, including “know your customer” due diligence obligations, would clearly help mitigate the first two trends. Investment advisers and companies would be newly required to evaluate potential clients and the source of their funds, assess AML/CFT risks accordingly, and report suspicious activity to law enforcement. Those efforts would help clean up what is now an unregulated

sector vulnerable to wrongdoing and thereby assist other financial institutions working to safeguard the U.S. financial system.

In the third category of cases marked by explicit wrongdoing, an AML/CFT rule for investment advisers and investment companies would help deter bad actors from misusing the investment sector, compel investment managers to screen clients more carefully and conduct more transaction monitoring to uncover misconduct, and provide another mechanism for regulators and law enforcement to conduct oversight, spot wrongdoing, and shut down hidden channels for illicit funds. Involving regulators would also introduce additional enforcement tools including cease and desist orders, suspensions and debarments, and a wide range of civil and administrative penalties for institutions and individuals.

CASE 01

Chinese state-owned venture capital firms pour huge sums into sensitive U.S. technology sector

As the epicenter of America's tech innovation, Silicon Valley has attracted a wide array of venture capital firms (VCFs) with ties to a Chinese government fund or other Chinese state-owned entities. A 2018 report from the Department of Defense found that Chinese venture capital investments granted the Chinese government "access (to) the crown jewels of U.S. innovation."⁵⁵ A Reuters report claims that Danhua Capital, a VCF based just outside Stanford University in California, invested in rising star startups that specialized in drones, cybersecurity, and artificial intelligence and had holdings in "some of the most sensitive technology sectors."⁵⁶ It also found that Danhua Capital – apparently unknown to many within the U.S. government – had been established and financed with the assistance of the Chinese government through Zhongguancun Development Group, a Chinese state-owned enterprise funded by the municipal government of Beijing.⁵⁷ Some analysts have concluded that Zhongguancun views Danhua as a vehicle for

technology transfer, since its website apparently states, "Zhongguancun capital goes out and foreign advanced technology and human capital is brought in."⁵⁸

Danhua Capital's investments have included the data management and security company Cohesity, which had contracts with both the U.S. Air Force and the U.S. Department of Energy.⁵⁹ Its holdings have also included drone startup Flirtey, which helped the U.S. Department of Transportation on projects to safely integrate drones into U.S. air space.⁶⁰

Danhua Capital is not a lone example. Reports indicate that more than 20 Silicon Valley venture capital firms have close ties to a Chinese government fund or another state-owned entity within China.⁶¹ Other VCFs that have been tied to Chinese backing and that were identified as active investors in Silicon Valley include Westlake Ventures, Oriza Ventures, and SAIC Capital.

Westlake Ventures is backed by the Hangzhou city government and, according to Reuters, has invested in at least 10 other venture capital funds based out of Silicon Valley, including Amino Capital which has a portfolio of US\$540 billion.⁶² Oriza Ventures reportedly belongs to the investment arm of the Suzhou municipal government and invested in startups working on artificial intelligence and self-driving car technology.⁶³ SAIC Capital is the venture capital arm of SAIC Motor, a Chinese state-owned automotive design and manufacturing company headquartered in Shanghai, that invested in autonomous driving, mapping, and AI startups. In addition, 500 Startups, a well-known startup accelerator, raised part of its main fund from the Hangzhou government. The relationship between the Chinese state and these venture capital firms, which are not currently obligated to disclose who their investors are, highlights unique economic and national security challenges for the United States.



Did you know?

Most VCFs invest through layers of funds, otherwise known as funds of funds. This practice can obscure both the identity of the investors and the source of the investment funds.

CASE 02

Russian attempts to steal sensitive technology may be advanced by a lack of CDD requirements for VCFs

The FBI has put the venture capital sector on alert to Russian investments that may be aimed at the covert transfer of sensitive technology. In a 2014 public op-ed, the FBI Boston office warned venture capital and other investment sectors of its belief that “the true motives of the Russian partners, who are often funded by their government, is to gain access to classified, sensitive and emerging technology from the companies.”⁶⁴ In certain instances, the FBI claimed a connection between the investment funds and a Russian-government financed science park in Moscow that reportedly shared stolen U.S. military technology with Russian military and defense contractors.⁶⁵

One firm suspected of covert technology transfer objectives is Rusnano USA. Russia’s government-owned venture capital firm Rusnano established Rusnano USA in Menlo Park, California. The firm’s investment strategy reportedly centers on nanotechnology acquisitions. According to a former intelligence officer, Rusnano USA was thought to be involved not only in the “acquisition of technology, but also inserting people into venture capital groups, in developing those relationships in Silicon Valley that allowed them to get their tentacles into everything.”⁶⁶ Another U.S. intelligence officer observed, “The Russians treated [Rusnano USA] as an intelligence platform, from which they launched operations.”⁶⁷

Another example is Bright Capital Fund, a Russian venture capital firm in Moscow that made investments in several U.S. firms that specialized in technology with military applications. Bright Capital Fund was established in 2010, by Mikhail Abyzov, a Russian billionaire and former minister for open government affairs. Abyzov was purportedly the previous “sole shareholder

of Promtehnologii, a weapons company that makes sniper rifles used by Russian-backed rebels in the Donbass of Ukraine and in Syria.”⁶⁸ The year Bright Capital Fund was founded, the firm invested US\$15 million in Alion Energy, a U.S.-based company that manufactured robots for assembling solar power plants.⁶⁹ Alion Energy also apparently had contracts with the U.S. Naval Research Laboratory. The next year, Bright Capital invested US\$75 million in Alta Devices, a company that develops solar panels used in drones, enabling unmanned aircraft to remain in flight for longer periods.⁷⁰ In 2016, Bright Capital invested in Augmented Pixels, a Palo Alto-based software startup that develops automatic navigation algorithms for unmanned aerial vehicles.⁷¹ Repeated venture capital investments in technology with defense applications by a firm with alleged ties to a U.S. adversary raises important questions about the vulnerability of the U.S. technology sector to espionage, technology theft, and other abuses introduced through the U.S. private investment industry.

CASES FROM THE 2020 FBI MEMO

The FBI intelligence memo leaked in 2020 marked a deepening recognition by the Bureau of the U.S. national security threats posed by the opacity and ease of misuse of private equity and hedge fund investments. Whereas the FBI previously analyzed private investment vehicles as a mechanism used to finance activities by foreign adversaries, its 2020 report also focused on how the private investment sector had become a conduit for money laundering, transnational organized crime, and sanctions evasion. Three cases cited in the FBI report demonstrate the national security risks.⁷²

CASE 03

Mexican drug cartels alleged to have used hedge funds to launder \$1 million a week

According to the FBI, Mexican drug cartels operating in Los Angeles and Orange counties recruited and paid people to open hedge fund accounts at private banking institutions. Each week, the cartel is believed to have laundered an average of US\$1 million through the hedge fund accounts and then withdrew the money to purchase gold, a commodity commonly used by organized crime and drug cartels to move money across international lines.⁷³ The FBI report has not been independently verified.

CASE 04

Firm with alleged ties to Russian organized crime used private equity firm to launder US\$100 million

According to the FBI, a private equity firm based in New York at one point received more than US\$100 million in wire transfers from an identified company that is based in Russia and that allegedly has ties with Russian organized crime.

CASE 05

Hedge funds offered up as means to facilitate trade-based money laundering schemes and evade U.S. sanctions

The FBI reported that, in 2019, an individual representing a hedge fund with operations in New York and London proposed a scheme to use shell corporations and hedge funds in Luxembourg and Guernsey to evade regulatory requirements when transacting with sanctioned companies. According to the FBI, based on human intelligence, the intent of the scheme was to help the companies export prohibited items from sanctioned countries into the United States.

Over a six-year period, 2006 to 2012, the pair allegedly funneled US\$100 million in illicit funds through financial institutions and anonymous shell companies located in Cyprus.

CASE 06

Illicit Russian and Ukrainian proceeds from high stakes gambling operations were purportedly invested through hedge funds

Anatoly Golubchik and Vadim Trincher – U.S.-based operatives for a massive Russian-American organized criminal enterprise – purportedly moved millions of dollars in illicit gambling proceeds through anonymous companies, real estate, and hedge fund investments.⁷⁴ The operation ran under the protection of Alimzhan Tokhtakhunov, the equivalent of a Mafia “godfather” in Russia’s criminal world.⁷⁵ The pair, later convicted for racketeering, set up one of the largest sportsbooks in history, primarily to cater to millionaire and billionaire clients, including oligarchs based in Russia and Ukraine.⁷⁶ The enterprise also apparently built out an extensive network of illegal high-stakes poker games and online gambling in Los

Angeles and New York that drew in U.S.-based Wall Street traders, professional athletes, and Hollywood stars.⁷⁷ The proceeds were then reportedly funneled to organized crime abroad.⁷⁸

Over a six-year period, 2006 to 2012, the pair allegedly funneled US\$100 million in illicit funds through financial institutions and anonymous shell companies located in Cyprus.

According to the Department of Justice, approximately half of the money, US\$50 million, was then transferred to the United States. Once here, the money was further moved through investments in hedge funds and real estate or through additional shell companies.⁷⁹ JP Morgan branch manager Ronald Uy pled guilty to assisting Trincher and his associates structure financial transactions to obscure the illegal origin of the funds.⁸⁰

ByteGrid had been hired by Maryland to handle the “statewide voter registration, candidacy, the election-management system, the online ballot-delivery system and the website for unofficial election-night results.”

CASE 07

Russian oligarch held stake in U.S. voting management firm through private equity

In 2018, Maryland Governor Larry Hogan, alongside state Senator Thomas V. Mike Miller Jr. and House Speaker Michael E. Busch, sought the assistance of the U.S. Department of Homeland Security after learning that ByteGrid LLC, a firm with a contract to manage Maryland’s voting system, was backed by investments from a Russian oligarch with apparent close ties to the Russian government.

ByteGrid had been hired by Maryland to handle the “statewide voter registration, candidacy, the election-management system, the online ballot-delivery system and the website for unofficial election-night results.”⁸¹ However, the state’s elected officials had been unaware until warned by the FBI⁸² that ByteGrid was financed by a private equity firm, AltPoint Capital Partners, whose fund manager and largest investor was a Russian oligarch named Vladimir Potanin.⁸³

Potanin, one of Russia’s wealthiest individuals, reportedly made his money after the fall of the Soviet Union through a series of privatization deals in the commodities markets.⁸⁴ Potanin also reportedly has close ties to Russian President Vladimir Putin.⁸⁵

The lack of disclosure of the Russian oligarch behind ByteGrid and AltPoint Capital raises national security concerns, highlighting how a hostile foreign interest could use private equity to potentially gain a measure of secret control over a firm administering important aspects of U.S. election infrastructure. The Department of Homeland Security issued the following statement at the time: “While we have no reason to believe Maryland state systems have been compromised, this serves as an opportunity to remind all critical infrastructure owners and operators to remain aware of key information regarding their contractors and subcontractors, including ownership, management, funding sources, and other activities.”⁸⁶

CASE 08

OneCoin scheme laundered fraudulent cryptocurrency windfalls through private equity

An international pyramid fraud scheme known as “OneCoin” used private equity funds to conceal, move, and launder substantial proceeds. According to the U.S. Justice Department, Mark Scott, a New York resident, corporate lawyer, and former partner at Locke Lord LLP law firm, worked with OneCoin designer Ruja Ignatova to launder US\$400 million in illicit proceeds through fraudulent investment funds that he expressly set up for that purpose.^{87, 88}

Scott established the fake private investment funds in the British Virgin Islands and dubbed them the “Fenero Funds.” He then moved the US\$400 million into the funds disguised as transfers from “wealthy European families.”⁸⁹ Scott further obscured the origin of the money by moving it through several Fenero Fund bank accounts in the Cayman Islands and Ireland, before finally transferring money back to the architect of the OneCoin scheme, Ignatova, and related entities.⁹⁰ She disappeared with the money in 2017.

Well-compensated for his money laundering services, Scott was paid more than US\$50 million. He used the funds to buy luxury cars, watches, a yacht, and several multi-million coastal homes in Massachusetts.⁹¹ In 2019, he

was convicted of conspiracy to commit money laundering and bank fraud.⁹²

This case demonstrates that fraudsters are willing and able to use private investment funds to hide and launder hundreds of millions of dollars in criminal proceeds. While Scott lied to banks, including those in the United States, about the origin of the funds so as to evade detection, additional AML safeguards and scrutiny in the private investment sector could have raised questions about his credentials and provided additional oversight and opportunities to freeze the proceeds and stop the fraud.

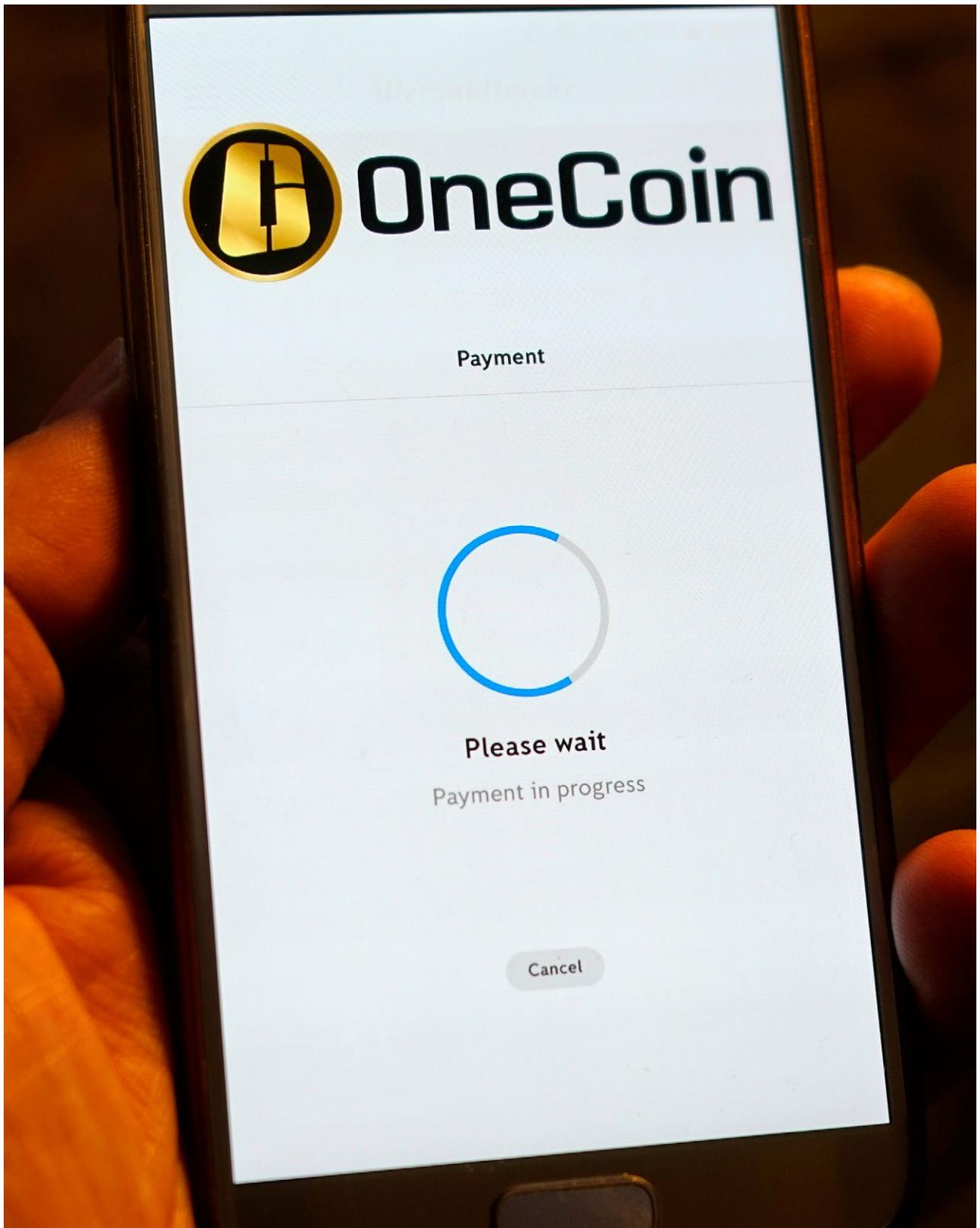
This case demonstrates that fraudsters are willing and able to use private investment funds to hide and launder hundreds of millions of dollars in criminal proceeds.



OneCoin Scheme

The OneCoin scheme is a cryptocurrency Ponzi arrangement that *Forbes* and others have described as one of the “biggest (financial) scams in history.” OneCoin operated as a multi-level marketing network through which members obtained commissions for recruiting others to purchase cryptocurrency packages.

OneCoin allegedly took money from more than three million victims worldwide, including victims living in the United States. The scheme is estimated to have stolen US\$4 billion from its victims and may still be operational. The mastermind behind the scheme is convicted fraudster and Bulgarian national, Ruja Ignatova, who has been on the run from law enforcement since 2017.





CASE 09

Real estate investment company purportedly laundered millions of dollars in drug proceeds

This case study examines private equity investments in the U.S. real estate market used to launder criminal proceeds. Sefira Capital LLC, a boutique investment company in Florida, invested more than US\$100 million in high-end commercial and residential real estate projects across the United States.⁹³ According to a Department of Justice civil forfeiture complaint, from 2016 to 2019, Sefira and its subsidiaries received millions of dollars in criminal proceeds from “investors” who were actually

drug trafficking organizations laundering funds through the Black Market Peso Exchange (see text box).⁹⁴

As part of 2018-2019 undercover investigations on the Black Market Peso exchange, the Drug Enforcement Administration (DEA) had transferred narcotics proceeds worth millions of dollars to Sefira subsidiaries at the instruction of money-laundering brokers.⁹⁵

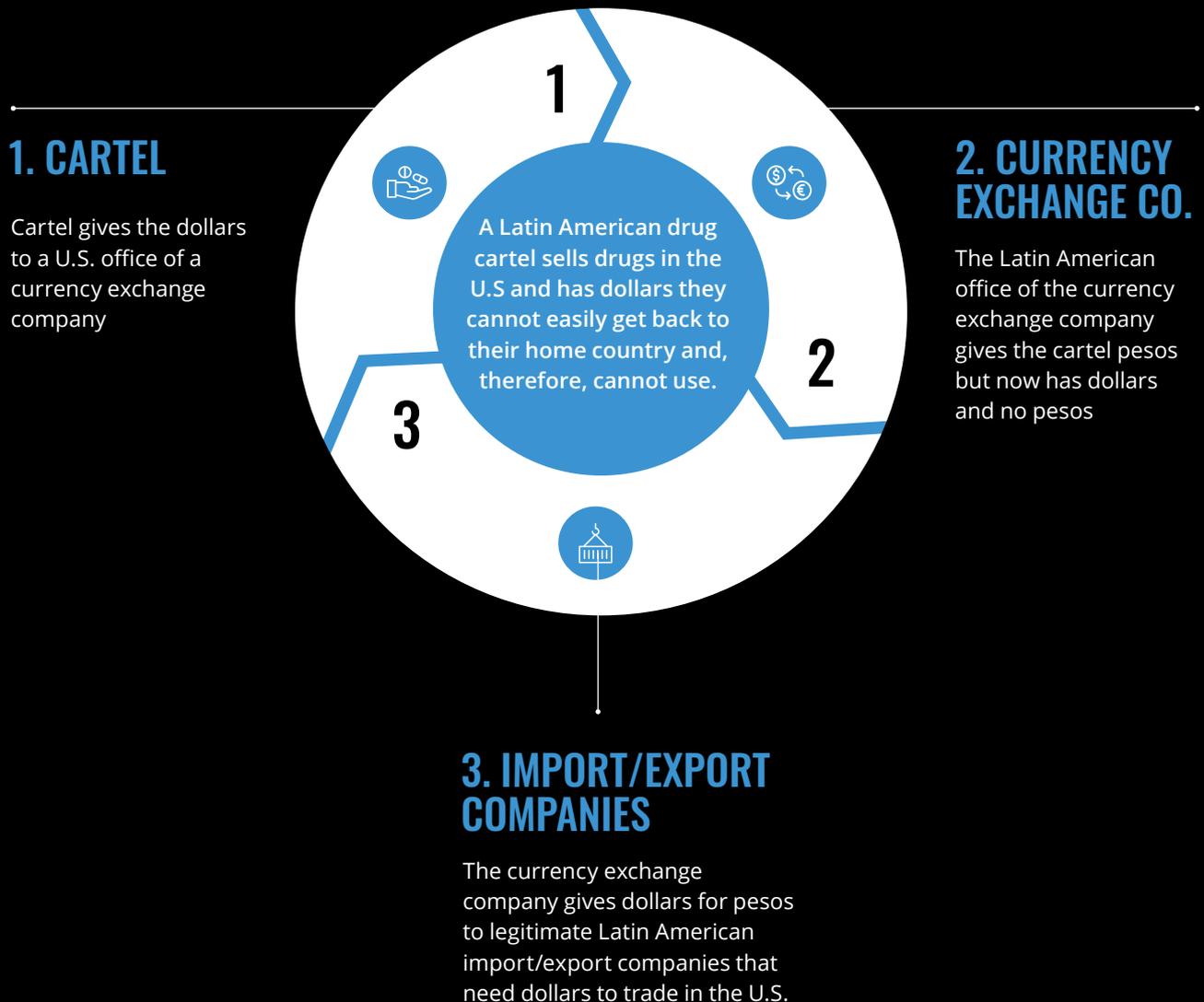
Sefira allegedly accepted the funds without asking questions about the true owners of the investment accounts or the source of their funds.⁹⁶ Likewise, Sefira apparently ignored discrepancies between the supposed investment amount and the actual amount Sefira

received, and between the purported identities of the investors and the entities sending the investments to Sefira.⁹⁷ After U.S. authorities brought a civil forfeiture action against the firm, Sefira ultimately settled the case for more than US\$50 million with the Department of Justice.⁹⁸

This case demonstrates that some private equity firms accept substantial sums of cash with few or no questions asked. If private equity firms were instead legally required to establish AML programs, screen clients, monitor account activity, and report suspicious transactions to law enforcement, the sector could better safeguard its operations and the U.S. financial system against dirty money.

BLACK MARKET PESO EXCHANGE

The Black Market Peso Exchange is a trade-based money laundering scheme that allows drug trafficking organizations to launder and transfer the value of their profits from the United States to their own country – all the while concealing the source and nature of the funds. While this scheme includes “peso” in the name after its notorious use by Colombian cartels, a wide array of threat actors use this methodology to launder drug proceeds into various currencies.



CASE 10

Swiss firm allegedly used opaque investment accounts to shield U.S. account holders from IRS scrutiny

This case study involves a foreign investment firm that was investigated by the U.S. Department of Justice for helping U.S. clients cheat on their taxes. Finacor is a small privately-held asset management firm based in Basel, Switzerland and licensed as a broker-dealer. Finacor's cross-border asset management business model allegedly enabled U.S. clients to open and maintain "undeclared accounts in Switzerland and conceal the assets and income they held in these accounts."⁹⁹ The accounts were "undeclared," because Finacor apparently did not report them to the IRS.

Finacor offered its clients two types of accounts: asset management accounts and fiduciary accounts (see text box).¹⁰⁰ Finacor managed client assets for both types of accounts, while holding the funds and assets at custodial banks in Switzerland. Finacor originally used UBS to hold the majority of its client assets, but had to change banks after UBS notified Finacor in 2008 that it would no longer service the accounts of U.S. citizens without an IRS Form W-9, which serves a request for a taxpayer identification number (TIN). Finacor moved its U.S. client

asset management accounts to another Swiss bank, after which it again transferred the undeclared U.S. citizen accounts to a custodian bank, in accounts opened in the name of Finacor itself. The firm then provided its clients with so-called "fiduciary account services." By transferring the client funds to accounts opened in the firm's own name, Finacor kept the client names off the bank's records and did not trigger CDD reviews of the clients by the bank. Instead, Finacor itself became solely responsible for carrying out CDD reviews for its clients.

Finacor's other services provided additional forms of secrecy to account holders, raising additional concerns about U.S. taxpayers' ability to shield assets from the IRS. Those services purportedly included: a) holding account-related mail at Finacor, so that mail concerning undeclared accounts would not be sent to the United States;

b) sending checks to the U.S. in amounts less than US\$10,000 to circumvent currency transaction reporting; c) using code words for money transfers to obscure the repatriation of undeclared assets and income back into the United States; and d) divesting U.S. securities from the undeclared U.S. accounts so that Finacor was not legally required to disclose U.S. client names under the terms of an agreement with the IRS.¹⁰¹

After the U.S. Department of Justice confronted Finacor with its misconduct, the firm reached a nonprosecution agreement with the Department and agreed to close its U.S. client accounts, turn over the account information, pay a fine, and cooperate with any prosecution or civil action taken against its clients. It also agreed to provide information on other banks working with secretive accounts.¹⁰²



Asset management accounts

In asset management accounts, client assets are held in the names of the clients at the custodian bank. Therefore, the custodian bank is required to know the identity of the client and carry out full CDD in line with AML/CFT obligations.

Fiduciary accounts

In fiduciary accounts, client assets are held in the name of the asset management business, in this case Finacor. Therefore, the only CDD review conducted by the bank was of Finacor. It did not and was not required to conduct any CDD reviews of Finacor's clients.

The risk of abuse of the U.S. investment market warrants expanding the AML reporting definition of investment advisers to include advisers to venture capital firms, family offices, and other market actors who are in a position to accept large amounts of suspect funds.

CASE 11

Financial advisers accused of providing undercover agent with advice on how to move illicit funds outside the U.S. using investment vehicles

The final case illustrates how the opacity of private investments can lead to additional risks in other industries by facilitating investments in those sectors, including the insurance industry. Stefan Seuss and Thomas Meyer, financial advisers based in Florida, were accused, in a joint FBI and IRS sting, of advising an undercover agent on how to move illicit funds abroad using offshore accounts and investment vehicles.¹⁰³

Seuss, an international wealth consultant, ran a business – Seuss and Partners LLC – based in Miami that, per a grand jury indictment, allegedly helped clients in the United States and elsewhere set up offshore companies and foreign bank accounts to conceal investments and any profits. Meyer was a Seuss associate specializing in life insurance. According to the indictment, when acting as a consultant for Florida-based

Global Life Solutions LLC, Meyer collaborated with Seuss to reinvest money that had been moved offshore into investments in the insurance sector. As the federal indictment explained, Meyer and Seuss allegedly offered “[c]lients a variety of financial services and investment opportunities that included, among other things, ... insurance settlement annuities.”¹⁰⁴

In a series of meetings and telephone conversations between 2007 and 2008, Seuss and Meyer met with an undercover federal agent who posed as a businessman who “illegally duplicated, distributed and sold CDs, DVDs and computer software to other businesses and individuals in New York and other parts of the United States” in violation of U.S. copyright infringement laws.¹⁰⁵ Seuss and Meyer were accused of actively advising the federal undercover agent on ways “to conceal and disguise the nature, location, source, ownership, and control of the funds ... believed to be the proceeds of illegal activity” and use those funds to purchase an investment vehicle.¹⁰⁶

FINDING THE SOLUTION

A change in U.S. policy would curb the risks highlighted by these case studies. FinCEN should bring the United States on par with its international allies and into better compliance with FATF recommendations by applying AML requirements to investment advisers and unregistered investment companies operating in the United States. This change would bring investment advisers into alignment with their counterparts in the U.S. financial system by requiring these advisers to stand up basic risk-based AML programs, file Suspicious Activity Reports (SARs) with FinCEN, and maintain accurate records.



FinCEN should go a step further to add investment advisers and unregistered investment companies to its shortlist of financial institutions required to conduct full CDD reviews for legal entities.¹⁰⁷ As our examples show, many criminal and threat actors run money through accounts owned by legal entities, adding a layer of opacity to these transactions. Requiring investment advisers and unregistered investment companies to follow “know your customer” rules would ensure that they screen prospective clients, identify entities’ beneficial owners, and monitor account activity. Investment advisers and unregistered investment companies should likewise be required to apply enhanced due

diligence standards including checks on the source of the funds and wealth – just like banks and security firms do – before opening accounts for certain high-risk foreign financial institutions or wealthy individuals with private banking accounts. Taking these precautions would help weed out the most egregious money-laundering abuses within U.S. markets.

Additionally, the risk of abuse of the U.S. investment market warrants expanding the AML reporting definition of investment advisers to include advisers to venture capital firms, family offices, and other market actors who are in a position to accept large amounts of suspect funds.

The evidence of abuse is only increasing, as is the size of the U.S. private investment market. It will only become easier over time for increasing amounts of illicit funds to taint legitimate U.S. investments.

As doors close on other financial secrecy vehicles – namely, anonymous U.S. shell companies, which are now subject to reporting under the Corporate Transparency Act – criminals will likely increase demand for opaque private investment funds.

An AML Rule for Investment Advisers and Investment Companies is Urgently Needed and Can be Created Without Any New Action from Congress

The Biden administration can act independently, through the Treasury Department, to bring investment advisers and unregistered investment companies under AML obligations, without any new action from Congress. Under the Bank Secrecy Act and its subsequent amendments, the Treasury Secretary has the authority to add entities to the list of “financial institutions” so long as the Treasury Secretary “determines that they engage in any activity similar to, related to, or substituted for, any of the listed businesses.”¹⁰⁸ Likewise, Treasury can require such institutions to keep records and file reports that provide 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.”¹⁰⁹ At the same time, “investment companies” are already a covered category under the BSA, and certain investment companies like mutual funds already comply with AML requirements; all the Biden administration needs to

do is revoke the 2002 temporary exemption, now nearly 20 years old, to bring the full scope of investment companies under BSA regulations.

As discussed previously, FinCEN has made several prior efforts to add investment advisers to its list of financial institutions and create AML program requirements for unregistered investment companies, but never finished the proposed rules. The difference now is that the evidence justifying action is much stronger than before. As the FBI intelligence bulletin notes, the current system is “not adequately designed to monitor and detect threat actors’ use of private investment funds to launder money.”¹¹⁰ The evidence of abuse is only increasing, as is the size of the U.S. private investment market. It will only become easier over time for increasing amounts of illicit funds to taint legitimate U.S. investments.

Likewise, as doors close on other financial secrecy vehicles – namely, anonymous U.S. shell companies, which are now subject to reporting under the Corporate Transparency Act – criminals will likely increase demand for opaque private investment funds. And that demand will increasingly target U.S. markets, as other countries toughen AML/CFT controls on investment advisers and investment companies operating within their borders.

Further, the Corporate Transparency Act, while inclusive of many businesses, exempts many investment advisers and pooled investment vehicles from reporting their true, “beneficial” owners to the forthcoming FinCEN database. While those exemptions are subject to review by the Government Accountability Office and Treasury Department, FinCEN action to impose AML/CFT program requirements and CDD obligations on investment advisers and investment companies could help shore up the sector and reduce the attractiveness of private investment funds as a vehicle to move illicit finance.¹¹¹

Finally, the political moment is right. The Biden administration can reclaim American leadership in the international anti-corruption space, in part, by reviewing domestic policies that fuel foreign corruption, especially in the lead up to the Summit for Democracy. The White House has started by featuring in its international agenda deliverables like the efforts to robustly implement the Corporate Transparency Act and to introduce greater transparency in the ownership of U.S. real estate.¹¹² Tackling money laundering through investment firms would likewise make an important contribution to reducing the inadvertent U.S. role in facilitating wealth drain from low- and middle-income

countries. Given its importance and the advanced stages of previous policymaking, analysts have identified shoring up the U.S. private investment industry as one of the most essential reforms in the campaign to strengthen global democracy and minimize the U.S. role in promoting corruption.¹¹³

Recommendations

+ FinCEN should issue new rules that include investment advisers among BSA-covered financial institutions and revoke the temporary exemption given to unregistered investment companies. The new rules should require both investment advisers and unregistered investment companies to establish AML/CFT programs and affirmatively engage in customer due diligence reviews of prospective investors.

+ Importantly, the rules should cover the full range of advisers in order to avoid loopholes that allow for exploitation by bad actors. Covered investment advisers should include:

1. Advisers currently registered with the U.S. Securities and Exchange Commission;

2. Advisers working solely with private equity, hedge funds, venture capital funds, rural business investment companies, family offices, or any other type of private fund; and

3. Advisers working as Foreign Private Advisers.

+ In particular, the new “know your customer” requirements should mandate (1) the identification of the beneficial owners of legal entities that open accounts, including single transaction clients; (2) evaluating all account holders and beneficial owners for money laundering risk; (3) ongoing monitoring of all accounts, with enhanced scrutiny of those with higher risk profiles; and (4) the filing of Suspicious Activity Reports with FinCEN.

CONCLUSION

The cases presented in this report show how opaque private investment vehicles can be misused by U.S. adversaries as well as criminals and other wrongdoers. The case studies demonstrate the need to bring greater transparency to the funds flowing through this multi-trillion dollar industry. Greater transparency will make it harder for actors looking to evade government scrutiny to enlist the private investment sector for help to stay in the shadows.

Moving forward to establish affirmative AML/CFT obligations for investment advisers and investment companies would ensure that hedge funds, private equity funds, venture capitalists and other investment firms finally follow the same anti-money laundering safeguards that other financial institutions follow to protect Americans and maintain the integrity of the U.S. financial system.



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