November 2, 2015

Via Electronic Submission (www.regulations.gov)

Ms. Jennifer Shasky Calvery, Director
Financial Crimes Enforcement Network
P.O Box 39
Vienna, VA 22183

Re: Anti-Money Laundering Program and Suspicious Activity Report Filing Requirements for Registered Investment Advisers, Docket Number FINCEN-2014-0003, RIN 1506-AB10

Dear Ms. Calvery:

The Investment Adviser Association[1] ("IAA") appreciates this opportunity to comment on the Financial Crimes Enforcement Network's proposal relating to anti-money laundering compliance by certain investment advisers.[2]

We recognize the importance of detecting and preventing money laundering and terrorist financing in all aspects of the financial system, and we understand FinCEN's ongoing efforts to evaluate whether to extend anti-money laundering concepts to advisers and other non-bank financial institutions. We appreciate that FinCEN's proposed flexible, risk-based approach to AML compliance permits each covered adviser to tailor its AML program to match the nature and scope of its advisory business.

At the same time, we urge FinCEN to reconsider the scope of its proposal. The BSA does not need to be extended to *all* investment advisers[3] with respect to *all* of their activities in order to have a comprehensive anti-money laundering regime in the United States. We

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[1] IAA is a not-for-profit association that represents the interests of investment adviser firms registered with the U.S. Securities and Exchange Commission ("SEC"). The IAA's membership consists of more than 550 firms that collectively manage approximately $16 trillion for a wide variety of individual and institutional investors, including pension plans, trusts, investment companies, private funds, endowments, foundations, and corporations. For more information, please visit www.investmentadviser.org.

[2] *See Anti-Money Laundering Program and Suspicious Activity Report Filing Requirements for Registered Investment Advisers*, 80 Fed. Reg. 52,680 (Sept. 1, 2015), available at http://www.gpo.gov/fdsys/pkg/FR-2015-09-01/pdf/2015-21318.pdf (the "Proposal"). The Proposal would, among other things, require advisers registered or required to be registered with the SEC to establish anti-money laundering ("AML") programs as required by the Bank Secrecy Act ("BSA") and report suspicious financial activity by filing suspicious activity reports ("SARs") pursuant to the BSA. The Proposal follows a substantially similar 2003 FinCEN proposal to require certain advisers to establish AML programs. *See Financial Crimes Enforcement Network; Anti-Money Laundering Programs for Investment Advisers*, 68 Fed. Reg. 23,646, 23,648 (May 5, 2003) (the "2003 Proposal").

[3] For simplicity, we use the terms "investment adviser" and "adviser" in this letter to refer to any investment adviser registered or required to be registered with the SEC, recognizing that there are other advisers not covered by the Proposal.

recommend that FinCEN carefully consider the varying types of advisers and the diversity of their advisory activities and client bases, and seek to extend the BSA only where doing so would fill a potential gap in our nation's anti-money laundering regime.

We also ask that certain other aspects of the Proposal be tailored to avoid duplication of regulatory efforts where the costs of compliance will significantly outweigh potential benefits. In many cases, advisers are only one of a series of financial institutions interfacing with a client in connection with a new advisory engagement, many of which already are required to perform AML reviews of the client. In other cases, advisers may have little or no direct contact with the ultimate client (as contrasted with other relevant intermediaries), or may deal with clients whose operations pose little or no money laundering risk. Certain aspects of the Proposal may not be necessary for these advisers, given that their advisory services and/or client base do not pose AML risks that justify application of the full array of AML obligations contemplated by the Proposal.

In this respect, regulators and the adviser community share a common objective: to balance the dual goals of maintaining the integrity and effectiveness of the proposed AML regime, while avoiding unjustified or duplicative regulatory burdens and costs on advisers whose operations pose no meaningful risk of money laundering. And we note that AML compliance costs—even on the risk-based basis contemplated by the Proposal—often are substantial. As discussed in Part V of this letter, we are concerned that the cost-benefit analysis reflected in the Proposal fails to correctly measure the substantial burden that these new programs would place on the industry, particularly with respect to smaller advisers, which constitute a majority of advisers in the industry.[4] By applying an asset-based "small entity" definition that primarily covers advisers that are not even eligible to register with the SEC (with limited exceptions),[5] FinCEN has not appropriately accounted for the rule's impact on the more than 6,000 SEC-registered advisers that have fewer than 10 non-clerical staff. In considering the economic burden of its proposal, FinCEN should consider these advisers to be small entities and take careful note of the potential ways in which the proposal might disproportionately impact them.[6]

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[4] In 2015, 57.3% of advisers registered with the SEC reported having fewer than ten non-clerical employees. INVESTMENT ADVISER ASSOCIATION & NATIONAL REGULATORY SERVICES, 2015 EVOLUTION REVOLUTION: A PROFILE OF THE INVESTMENT ADVISER PROFESSION 24 (2015), *available at* https://www.investmentadviser.org/eweb/docs/Publications_News/EVREV/evolution_revolution_2015.pdf (*hereinafter*, "EVOLUTION REVOLUTION").

[5] Section 203A(a)(1)(A) of the Investment Advisers Act of 1940 (15 U.S.C. § 80b-3a(a)(1)(A)) provides that "[n]o investment adviser that is regulated or required to be regulated as an investment adviser in the State in which it maintains its principal office and place of business shall register [as an investment adviser with the SEC], unless the investment adviser . . . [h]as assets under management of not less than $25,000,000." Although there are certain exceptions to this prohibition, less than 8% of advisers registered with the SEC in 2015 reported having less than $25,000,000 under management. *See* EVOLUTION REVOLUTION, at 10.

[6] We recognize that the Proposal elected to adopt the SEC's definition of "small entity," in an effort to create consistency and uniformity with the SEC's standards. However, by choosing the SEC's AUM-based standard over the standard published by the Small Business Administration, which instead considers a firm's annual receipts in

We believe that the changes we recommend would improve the efficiency of the Proposal's intended regulation of advisers by excluding or exempting from coverage certain firms or certain low-risk activities, enhance the ability of advisers to tailor the Proposal's AML requirements to their businesses, and enable advisers to rely on certain efforts of other AML-regulated entities in the financial system or within an adviser's own organization. This comment letter also discusses, and seeks guidance concerning, certain practical implications of the Proposal.

I. Background on the Investment Advisory Profession

As a preliminary matter, we feel compelled to clarify one point. The Proposal begins by noting FinCEN's concern that "[a]s 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."[7] We respectfully submit that this statement is simply not true and reflects a fundamental misunderstanding of the nature and scope of services provided by advisers. For reasons discussed below, advisers do not provide any way—much less "a low risk way"—for a client to bypass banks, broker-dealers, or other financial institutions covered by the BSA and enter the U.S. financial system.

Unlike other types of financial service providers, the client relationship for an investment adviser does not begin with an initial "deposit." Rather, it begins with the client entering into an investment management agreement with the adviser, pursuant to which the adviser agrees to manage the client's assets on a discretionary basis or provide non-discretionary investment advice that clients may implement in their own accounts. In either case, the actual physical custody of the cash and securities in the client's account is maintained by a "qualified custodian," such as a bank or broker-dealer,[8] and the client merely authorizes that bank or broker-dealer to accept investment management instructions from the adviser.[9] Accordingly, the

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determining its status as a small business (*see* 13 C.F.R. § 121.201), we believe the Proposal comes to a far different conclusion on the impact to small businesses than it otherwise would have. *See* Part V of this letter.

[7] Proposal, at 52,681.

[8] Advisers themselves rarely serve as qualified custodians. In 2015, only 78 advisers (or 0.7% of advisers) reported acting as qualified custodians in connection with their advisory services. See EVOLUTION REVOLUTION, at 20. That a small number of advisers serve as qualified custodians themselves is not a gap in the AML regime: in cases where the adviser acts as the qualified custodian, the adviser also is either a bank or broker and acting as a qualified custodian in such capacity—not as an adviser. Further, we note that, in 2015, only a very small number of advisers reported being entities that could be eligible under the so-called "Custody Rule" (17 C.F.R. § 275.206(4)-2) to serve as qualified custodians: only 4% are dually registered with the SEC as broker-dealers, only 0.2% are banks, and only 0.2% are futures commission merchants. *Id*. at 28. We further note that, notwithstanding the assertion in the Proposal that advisers "are often dually registered as a broker-dealer in securities or affiliated with" other BSA-defined financial institutions, our statistics find that less than 21% of advisers report an affiliation with a broker-dealer, and just over 7% report an affiliation with a bank or thrift institution. *Id*. at 29-30.

[9] As an example of the rigors imposed by the Custody Rule, a registered adviser asked the SEC staff whether, in the event that the adviser inadvertently received securities directly from a client, the adviser could simply forward those securities on to the client's qualified custodian rather than returning them to the client (to, in turn, be sent directly to

process for opening and funding a client account necessarily involves SEC-registered broker-dealers or regulated banking institutions that are already subject to extensive AML regulatory obligations under the BSA.

As a result, compared with other financial institutions involved in the account opening process, advisers in many cases may not be as well-positioned to view how the client's account is funded, where withdrawals from the account are sent, or whether there is unusual wire activity.[10] That said, we understand that under certain circumstances it may be possible for an adviser that has a direct relationship with an individual client to recognize behavior that may be suspicious. Even in that respect, however, FinCEN should understand that the typical advisory client relationship is fundamentally not an attractive medium for money launderers. In the traditional advisory model, the adviser—pursuant to a written contract with the client—provides continuous and regular supervision and/or management of the client's securities portfolios. This does not provide an expedient or cost-effective means to "transform" the character of illicit funds into legitimate assets of the accountholder. Customarily, advisers receive a percentage of assets under management and/or appreciation in value of the client's account as remuneration rather than compensation on a transaction by transaction basis. This percentage-based compensation structure aligns the interests of the adviser and the client and encourages a long-term adviser-client relationship. In the AML context, this type of compensation would impose a relatively substantial cost on persons intending to use advisers for money laundering activities.

Moreover, the vast majority of investment advisory relationships are created to achieve clients' investment objectives over the long term. Investment advisers thus anticipate that a client's assets will remain in the custodial account without frequent withdrawals or deposits that would interfere with the adviser's implementation of the client's selected investment strategy.[11] This expectation of stable and long-term retention of client assets in the custodial account is particularly true when the adviser possesses discretionary authority over a client's assets—*i.e.*, when the adviser is authorized to make investment decisions for the client without the client's consent for each transaction (although within the clients' established investment restrictions and

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the qualified custodian). The staff responded negatively, stating that, if the adviser did not return the securities to the client within three business days, "the adviser not only has custody but has also violated the amended rule's requirement that client securities be maintained in an account with a qualified custodian." *See* Staff Responses to Questions About the Custody Rule, *available at* http://www.sec.gov/divisions/investment/custody_faq_030510.htm (last updated Sept. 1, 2013) (Question II.1). Accordingly, the Custody Rule has the impact of removing many advisers from the chain of custody over funds transferred into and out of a client's custodial account.

[10] IAA acknowledges that there is significant variation among investment advisers with regard to their visibility to, and involvement in, funding and other cash transactions related to their clients' accounts. For example, advisers to retail clients may be more actively involved in facilitating the account opening and funding process for their clients, including forwarding wire instructions from the client to the custodian, while this may be less common among advisers to institutional clients. However, this does not alter the fundamental requirement under the Custody Rule that such transactions must be effected through other regulated financial institutions (except in the very limited circumstance where the investment adviser is itself acting as the client's qualified custodian).

[11] *Cf. Financial Crimes Enforcement Network; Anti-Money Laundering Programs for Unregistered Investment Companies*, 67 Fed. Reg. 187 at 60619 (Sept. 26, 2002) (noting that entities requiring lengthy investment periods are less susceptible to money laundering).

guidelines). Such expectation is commonly enforced by the adviser through minimum account size thresholds for its client accounts, which may in some cases be coupled with other contractual conditions or limitations on liquidity. In light of these expectations, advisers generally are not attractive to money launderers that seek to quickly and frequently move funds in and out of the financial system without raising suspicion.

With this background, we discuss below certain advisers whose activities raise minimal money laundering concerns and that IAA believes may be excluded or exempted from the Proposal's intended AML regime.

II. The Proposal Should Provide Exclusions or Exemptions for Certain Types of Advisory Business

The Proposal imposes AML obligations on all investment advisers, irrespective of the nature of their clients or their types of advisory business. However, a significant number of these advisers provide services to clients and/or engage in advisory activities that do not, in IAA's view, raise money laundering risks that need to be addressed by FinCEN's proposed rules.

1. Advisory Services Not Involving Management of Client Assets.

Certain advisers provide non-management advisory services, such as nondiscretionary financial planning and publication of securities-related newsletters, impersonal "model portfolios" or research reports ("Non-Management Services").[12] In providing these types of services, advisers are functioning entirely outside of the "payment chain"—the adviser neither manages, directly or indirectly, the client's assets nor participates in the transmittal of any client funds to or from any recipient. Accordingly, in these circumstances, there is no risk that the adviser will be an entry point for money laundering activities, and the adviser would not have access to sufficient information about the client's account to detect suspicious financial activity. Indeed, in many instances, advisers may not even possess the names of or other identifying information about the "clients" who receive Non-Management Services. Applying AML regulations to the adviser in this context would not meaningfully contribute to the AML regime. We therefore request that FinCEN consider modifying the Proposal to provide that advisers need not include within the scope of their AML programs those clients to which they provide only Non-Management Services.

2. Advisory Services to AML-Regulated Entities, Such As Registered Investment Companies.

Investment advisers serve a diverse range of clients, including individuals, banks, mutual funds, pension funds, hedge funds, charitable organizations, corporations, and state or municipal entities. Certain types of advisory clients—most notably, banking institutions, registered

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[12] As of April 8, 2015, 410 advisers reported on Form ADV that they have no clients. EVOLUTION REVOLUTION, at 14. Similarly, 585 advisers reported having no assets under management. EVOLUTION REVOLUTION, Supplemental information, line 359.

investment companies (e.g., mutual funds), insurance companies and registered broker-dealers—are already subject to the extensive AML requirements of the BSA (such entities, collectively, "AML-Regulated Entities"). Consequently, assets that an adviser receives from a client that is itself an AML-Regulated Entity have already been subject to an AML review before allocation to the adviser for management. Therefore, requiring an adviser to conduct an AML review of clients that are AML-Regulated Entities would be needlessly duplicative of AML protections already in place.

The foregoing also is true when clients enter into advisory contracts with an AML-Regulated Entity, which then enters into sub-advisory contracts with advisers ("AML-Covered Sub-Advisory Arrangements"). In AML-Covered Sub-Advisory Arrangements, the AML-Regulated Entity acts as the primary point of contact with its clients, is responsible for conducting due diligence and complying with AML requirements, and has the ability and authority to monitor and collect information about its clients' account activities. A notable example is the traditional, bundled "wrap fee" program sponsored by a registered broker-dealer unaffiliated with the program's sub-advisers. In this arrangement, clients traditionally enter into agreements for brokerage and advisory services with the registered broker-dealer sponsoring the program, which is subject to AML requirements under the BSA and is responsible for all client-level services (e.g., recordkeeping, account maintenance, reconciliation, etc.). The broker-dealer then enters into sub-advisory contracts with advisers to invest the client assets invested in the program, based on the parameters set by the sponsor. Therefore, a sub-adviser that provides advisory services under an AML-Covered Sub-Advisory Arrangement has minimal or no contact with the AML-Regulated Entity's clients and is asked to manage assets that have already undergone an AML screening. Further, the sub-adviser likely does not possess or have access to information about the AML-Regulated Entity's clients that would permit the sub-adviser to conduct an AML review that would add value to the AML review already conducted in the first-instance by the AML-Regulated Entity.

In both of these contexts, an additional layer of AML review by an adviser with respect to a client that is an AML-Regulated Entity or a client pursuant to an AML-Covered Sub-Advisory Arrangement would be duplicative and impose a substantial cost and burden on advisers without providing a commensurate improvement in the detection and prevention of illicit money laundering activities. We strongly recommend that the Proposal be amended to provide that an adviser is not required to include AML-Regulated Entity clients and AML-Covered Sub-Advisory Arrangements within the scope of its AML program. This approach would substantially reduce the overall regulatory burden of the Proposal without creating any gaps in AML protections. While the approach would entirely exempt advisers that exclusively serve AML-Regulated Entities, those entities (and their investors) are all covered. For example, an adviser to a mutual fund would be exempt, but the mutual fund itself would remain subject to the full panoply of AML protections.

We note that this requested relief would be conceptually consistent with the exclusion included in the 2003 Proposal that permitted advisers to exclude from their AML programs pooled investment vehicles that are themselves subject to, or sponsored by financial institutions

subject to, AML requirements under BSA rules.[13] IAA would welcome a similar effort to avoid overlapping and duplicative AML regulation in respect of the current Proposal.

3. Sub-Advisory Services.

Another common and important circumstance where we believe relief is warranted is in the context of sub-advisory relationships, where one adviser (the "Primary Adviser") takes responsibility for the day-to-day administration of a client's account and client-related account services (such as reporting and recordkeeping), but contracts with one or more unaffiliated advisers (each, a "Sub-Adviser") to make investment management decisions for the account (collectively, "Sub-Advisory Arrangements"). Sub-Advisory Arrangements can exist in a number of formats, including managed account "platforms," wrap fee programs, unified managed accounts and other sub-advised accounts, as well as collective investment funds where a Primary Adviser sponsors the fund and retains Sub-Advisers to manage the fund's investments. In all of these cases, the common factor is that the Primary Adviser or its designated agent(s) (but, importantly, not the Sub-Adviser) is responsible for soliciting potential investors and raising capital, collecting information and documentation regarding the investors' eligibility to invest under securities and other laws and regulations, and selecting and liaising with the custodians that will hold clients' assets. Furthermore, the Primary Adviser possesses the authority to appoint and replace each Sub-Adviser, which functions solely as a service provider that has the discrete responsibility of managing the assets allocated to it under the Sub-Advisory Arrangement.

In this regard, the arrangement is similar to those described in Part II.2 above in that, as a result of the legal and practical structure of Sub-Advisory Arrangements, a Sub-Adviser likely will not possess or have access to detailed information about the end-clients in the Sub-Advisory Arrangement and, therefore, is not well-positioned to conduct a meaningful AML review. In some cases, this lack of transparency may indeed be critical to the commercial (e.g., due to competitive concerns) or legal (e.g., due to varying privacy laws applicable to non-U.S. clients) viability of the Sub-Advisory Arrangement. Moreover, as an unaffiliated party involved in only the investment management aspects of the Sub-Advisory Arrangement, the Sub-Adviser often will not have investor-level visibility into the circumstances surrounding subscriptions, redemptions and other cash moves impacting the account. As such, the Sub-Adviser is unlikely to have visibility into the type of client-level account activity that might otherwise trigger suspicious activity reporting obligations.

Although we acknowledge that Primary Advisers currently may not be required to implement AML programs in connection with Sub-Advisory Arrangements, they generally

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[13] *See* 2003 Proposal ("In some instances, investment advisers that would be subject to the proposed rule advise pooled investment vehicles that are themselves required to maintain anti-money laundering programs under BSA rules, such as mutual funds, or that are sponsored or administered by financial institutions subject to such requirements. To prevent overlap and redundancy, the proposed rule would permit investment advisers covered by the rule to exclude from their anti-money laundering programs any investment vehicle they advise that is subject to an anti-money laundering program requirement under BSA rules.") (citation omitted).

would be required to do so under the Proposal. For these reasons, IAA believes that subjecting Sub-Advisers to AML obligations is likely not the most appropriate or effective means to implement AML protections in a Sub-Advisory Arrangement, and could prove disruptive to an important segment of the asset management industry. We therefore request that FinCEN relieve Sub-Advisers unaffiliated with their Primary Advisers from the AML requirements of the Proposal.

4. Advisory Services to Low-Risk Clients.

Certain advisory clients, although not themselves subject to extensive AML requirements, nonetheless present a low risk of suspicious activity. Pension plans, employees' securities companies ("ESCs"), and publicly traded corporations are notable examples. Pension plans are created to secure employees' (*i.e.*, plan participants') retirement benefits, are funded by contributions from participants' salaries and from the sponsoring employer, and participants are not permitted to withdraw their plan contributions for extended periods of time, in the ordinary course. ESCs are companies all of the outstanding securities of which are beneficially owned by current and former employees of a single employer (or group of affiliated employers), immediate family members thereof, and/or the relevant employer(s),[14] and are established to benefit, reward, and retain employees. Public corporations generate income from active business operations, are subject to significant audit, securities, and other regulatory requirements, and are heavily regulated by the SEC. For these reasons, advisory accounts for pension plans, ESCs,[15] and publicly traded corporations present a low risk of money laundering. Several other advisory clients would fall into this low-risk category, including those that are government entities, such as municipal or state agencies; governmental pension plans; non-profit organizations; higher education endowment funds; and multi-employer plans (so-called "Taft-Hartley plans"). Moreover, as noted above, even such low-risk accounts will often be held in custody with a financial institution that is already required to conduct BSA-compliant AML reviews of the account, adding an additional layer of security.

We ask that FinCEN recognize the minimal risk presented by these types of advisory clients and exclude from the Proposal's AML requirements advisers advising only such low-risk

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[14] ESCs are established pursuant to Section 2(a)(13) of the Investment Company Act of 1940, as amended (15 U.S.C. § 80a-2(a)(13)) and refer to "any investment company or similar issuer all of the outstanding securities of which (other than short-term paper) are beneficially owned (A) by the employees or persons on retainer of a single employer or of two or more employers each of which is an affiliated company of the other, (B) by former employees of such employer or employers, (C) by members of the immediate family of such employees, persons on retainer, or former employees, (D) by any two or more of the foregoing classes of persons, or (E) by such employer or employers together with any one or more of the foregoing classes of persons."

[15] We note that, in its proposed (but subsequently withdrawn) AML program rules for unregistered investment companies, FinCEN excepted ESCs and certain categories of employee benefit plans from the proposed AML program requirements, on the grounds that such structures are not likely to be used for money laundering purposes by third parties "given their size, structure and purpose." *Financial Crimes Enforcement Network; Anti-Money Laundering Programs for Unregistered Investment Companies*, 67 Fed. Reg. 187 at 60620 (Sept. 26, 2002).

clients, or clarify that advisers' AML obligations under the Proposal with respect to these entities would be effectively *de minimis*.

5. Application of the Proposal to Foreign Advisers.

FinCEN has asked for comment on whether the Proposal should apply to SEC-registered advisers that have no place of business inside the United States ("Foreign Advisers"). FinCEN has long recognized that the BSA does not apply to foreign financial institutions, foreign operations of U.S. financial institutions, and foreign bank branches, and has tailored its FAQs and examination manuals accordingly.[16] This jurisdictional approach was reflected in the 2003 Proposal, which defined "investment adviser" to include only those advisers "whose principal office and place of business is located in the United States,"[17] but that refinement was not carried forward into the current Proposal. Similarly, the SEC has a well-established position that the substantive requirements of the Investment Advisers Act of 1940, as amended (the "Advisers Act"), do not apply to Foreign Advisers with respect to their foreign clients.[18] By not taking into account the principal locations from which Foreign Advisers conduct their businesses, the Proposal would treat such firms differently than many other AML-Regulated Entities.[19] These limitations on extraterritoriality are very important, as many firms are located in jurisdictions where legal conflicts could arise between the Proposal's requirements and local confidentiality and privacy laws.

Consistent with the BSA's treatment of foreign bank branches and many other AML-Regulated Entities, the Proposal should not apply to Foreign Advisers. If FinCEN should determine otherwise, it must at a minimum clarify that the application of the Proposal relates solely to the U.S. clients of Foreign Advisers, and even in that regard, that Foreign Advisers may appropriately tailor their suspicious activity monitoring and reporting to comport with their local privacy and other laws.

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[16] *See* 31 U.S.C. § 5312(a)(2) (definition of the term "financial institution" does not include foreign branches or foreign financial institutions). *See also* FFIEC Bank Secrecy Act Anti-Money Laundering Examination Manual, at https://www.ffiec.gov/bsa_aml_infobase/pages_manual/OLM_041.htm ("overseas branches or subsidiaries may find it necessary to tailor monitoring approaches as a result of local privacy laws").

[17] *See* 2003 Proposal, at 23,652 (proposed definition).

[18] *See American Bar Association, Sub-Committee on Private Investment Entities*, SEC No-Action Letter (Aug. 10, 2006).

[19] For example, the suspicious activity reporting requirements for broker-dealers (*see* 31 C.F.R. § 1023.320(a)(1)), futures commission merchants and (commodities) introducing brokers (*see* 31 C.F.R. § 1026.320(a)(1)) apply to such firms "within the United States." We also note that many of the definitions for other regulated categories show a similar jurisdictional approach. *See*, *e.g.*, 31 C.F.R. § 1010.100(d) (definition of "bank" refers to "[e]ach agent, agency, branch or office *within the United States* . . . ."); 31 C.F.R. § 1025.100(g) (definition of "insurance company or insurer" refers to "any person engaged *within the United States* as a business in the issuing or underwriting of any covered product"); 31 C.F.R. § 1010.100(lll) (definition of "loan or finance company" refers to "[a] person engaged in activities that take place *wholly or in substantial part within the United States* . . . .") (*emphasis added*). In light of the factors cited elsewhere in this letter, we are not aware of a compelling reason that Foreign Advisers should be treated differently than these other regulated businesses.

III. The Proposal Should be Amended to Ease the Practical Burden on Advisers in Implementing AML Programs

Under the Proposal, every adviser would be required to establish an AML program that is reasonably designed to prevent the adviser from being used for money laundering. The AML program would be required to meet four minimum requirements: (i) implementation of internal AML policies, procedures, and controls; (ii) designation of a person(s) responsible for administering the AML program; (iii) ongoing AML program training for appropriate persons; and (iv) independent testing of compliance. Below, we address certain practical issues concerning the manner in which the Proposal requires implementation of the AML program.

1. Approval.

The Proposal would require that each adviser's AML program be approved in writing by its board of directors or trustees, or if it does not have a board, by its sole proprietor, general partner, trustee, or other persons that have functions similar to a board of directors. IAA agrees that each adviser should ensure that its AML program receives approval and support at an appropriately high level of management. However, owners and principals may not be the appropriate parties to approve AML programs, as they may not be the most familiar with the operational aspects of the adviser's AML program or compliance program generally. We recommend instead that FinCEN's final rules permit approval by a member of senior management. This would be consistent with the corresponding rules for broker-dealers[20] and with the integration of the AML program into the adviser's existing compliance program.

2. AML Compliance Officer.

The Proposal also would require that the compliance officer responsible for the AML program be, among other things, knowledgeable and competent regarding FinCEN's regulatory requirements and have "full responsibility and authority to develop and enforce appropriate policies and procedures."[21] The Proposal further requires that the compliance officer be an "officer" of the adviser. We note that many advisers, by virtue of their organizational structures, may not generally have formally designated corporate "officers" who are well-suited to serving as the adviser's AML compliance officer. We recommend that the Proposal be amended to permit any sufficiently senior employee of the adviser (including its chief compliance officer)—or of any other entity within the adviser's organizational structure—to serve as the AML compliance officer, as long as such employee meets all of the other requirements set forth in the Proposal and is either a member of, or reports directly to, the adviser's senior management. This would ensure that the AML compliance officer has sufficient authority to oversee implementation of the AML program while also granting advisers flexibility to structure their operations.

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[20] *See* FINRA Rule 3310.

[21] Proposal, at 52,689.

There may be a minor point to clarify in this regard. As FinCEN notes in the Proposal, SEC Rule 206(4)-7 currently requires advisers to establish written compliance policies and procedures reasonably designed to prevent violation of the Advisers Act and its rules and to designate a chief compliance officer to oversee and implement those policies and procedures. We appreciate that FinCEN states that it "contemplates that investment advisers would be able to adapt existing policies, procedures, and internal controls in order to comply with the rules FinCEN is proposing today."[22] Many advisers may wish to integrate the Proposal's AML program requirement into their existing compliance programs under SEC Rule 206(4)-7, and also may decide to designate their chief compliance officer as the AML officer responsible for their AML program. We see nothing in the Proposal that would prevent an adviser from doing so. Although perhaps unnecessary, in adopting the final rule, FinCEN may want to expressly confirm that it shares that view.

3. Independent Testing.

Finally, the Proposal requires advisers to engage in periodic independent testing of their AML programs, with such testing to be conducted by qualified outside parties or by employees of the adviser. The Proposal prohibits the personnel tasked with independent testing from being involved in the implementation or oversight of the adviser's AML program.

We are extremely concerned that this requirement will place a substantial burden on advisers, especially smaller advisers that employ a limited number of individuals. For them, the requirement that the testing be independent is tantamount to a requirement to hire an external party. According to our most recent report on the adviser industry, 57.3% of advisers reported having ten or fewer non-clerical employees.[23] In fact, the median number of employees reported by SEC-registered advisers is eight.[24] It is unlikely that a smaller adviser will have employees that are sufficiently knowledgeable about the adviser's AML program but that are not already involved in its implementation or oversight to conduct the required review. As a result, they would have to retain qualified outside parties for independent testing. This could be a significant cost, with a significant impact, as these smaller firms are the least financially able to hire outside consultants.

We request that FinCEN provide flexibility in the independent testing requirement and permit smaller advisers to employ an internal testing program that may include employees involved in the AML program and/or ongoing BSA compliance. We note that advisers already are obligated to perform annual compliance reviews under SEC regulations, but the Proposal would preclude the knowledgeable compliance staff who perform these reviews from participating in advisers' independent AML testing and effectively integrating the testing into the

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[22] Proposal, at 52,686.

[23] EVOLUTION REVOLUTION, at 24.

[24] *Id.*

existing compliance program.[25] IAA believes that this constraint would place an unnecessary burden and expense on advisers, preventing them from allocating their valuable compliance resources in an optimal manner.

In addition, we appreciate the significant flexibility the Proposal provides regarding the frequency of independent testing and ask for confirmation that certain firms may choose to conduct testing on a less-than-annual basis (such as every two or three years) when, for example, a firm has a relatively stable and/or lower-risk client base (such as an adviser that manages money only for well-known institutional clients). We believe that this is a critical element to making the Proposal workable across the widely varied population of advisers registered with the SEC.

4. Look-Through Obligations of Advisers to Unregistered Pooled Investment Vehicles.

We appreciate FinCEN's risk-based approach that permits advisers to risk-rate their advisory services based on the money-laundering risks associated with particular types of clients. The Proposal notes, in particular, that an adviser acting as the primary adviser to a private fund or other unregistered pooled investment vehicle (a "Private Fund") "should have access to information about the identities and transactions of the underlying or individual investors" in the Fund and should consider the money-laundering risks presented by such investors[26]; the Proposal further recognizes the potential lack of transparency if those underlying investors are themselves entities.

We ask for confirmation that an adviser's obligation to assess money-laundering risks relating to the underlying investors of a Private Fund applies only when, and only to the extent that, the adviser is the primary adviser to that Private Fund (and not in the case of a Sub-Advisory Arrangement, as discussed in Part II above) and has access to information about the Private Fund's underlying investors. An adviser serving as the Private Fund's primary adviser should have information about that Private Fund's underlying investors in the ordinary course. It would not have that information, however, in an unaffiliated "fund-of-funds" structure. In that case, the adviser to an *investee* fund in the structure should not be required to "look through" and assess the risks presented by the underlying investors in an *investing* fund, unless such adviser also acts as the primary adviser to the investing fund and thus possesses (or has access to) information about such underlying investors in the ordinary course.

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[25] Such flexibility has been afforded by FinCEN in the past—for example, the rules governing AML programs for loan and finance companies provide that independent testing may be conducted "by any officer or employee of the loan or finance company," other than the designated AML compliance officer. 31 C.F.R. § 1029.210.

[26] *Id.* at 52,688.

IV. The Proposal Should Permit Advisers to Share SARs Within Their Organizational Structures and Provide Guidance on Coordinating with Custodians in respect of SAR Obligations

Investment advisers subject to the Proposal would be required to monitor client transactions for suspicious activity and to file SARs when the adviser knows, suspects, or has reason to suspect that a transaction involving $5,000 or more in assets involves suspicious activity as defined by relevant BSA rules. IAA recognizes that the examples of suspicious activity red flags set forth in the Proposal may have been drawn from IAA's 2003 comment letter,[27] and we appreciate FinCEN's consideration of our prior comments. IAA believes that these red flags are tailored to the types of suspicious activity that advisers could feasibly monitor.

We note that the Proposal does not authorize the sharing of SARs within an adviser's organizational structure absent further FinCEN guidance or rulemaking. The Proposal, however, recognizes that banks, broker-dealers, mutual funds, and certain other "financial institutions" currently are permitted by FinCEN interpretive guidance to share SARs within their corporate organizational structures, subject to certain limitations.[28] IAA urges FinCEN to issue similar guidance permitting the sharing of SARs within an adviser's corporate organizational structure (e.g., with the adviser's controlling company or affiliates (such as a pooled investment vehicle sponsored by the adviser)). To the extent advisers become subject to suspicious activity reporting requirements under the Proposal,[29] we ask that they be granted the same or similar flexibility as other financial institutions to share SARs, as well as AML-related personnel and training, within their organizations. IAA believes that this flexibility would facilitate and make more efficient efforts to identify money laundering and terrorist financing activities.

Further, IAA requests that FinCEN provide guidance concerning the ability of advisers to delegate aspects of account monitoring and to coordinate or integrate their related SAR reporting obligations with qualified custodians that hold client assets. Although the proposed rule would allow contractual delegation of AML obligations to qualified custodians, FinCEN should clarify that an adviser may reasonably rely on a certification from the qualified custodian to meet the adviser's obligations to "remain fully responsible" for the effectiveness of the delegated part of the adviser's AML program. As noted above in Part I, advisers rarely possess physical custody of clients' assets, which are in the vast majority of cases held at other qualified custodians such as banks and broker-dealers. Because such qualified custodians often will have the greatest visibility into account transactions, and will likely have greater experience with suspicious activity detection and reporting (given their longer experience with BSA regulation), it would be

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[27] *See* Proposal, at 52,691; ICAA Letter to Treasury re: Proposed Anti-Money Laundering Rules for Investment Advisers (July 2, 2003), available at https://www.investmentadviser.org/eweb/docs/Publications_News/Comments_and_Statements/Archived_Comments_Statements/letterscompendium-2003.pdf.

[28] *See* Proposal, at 52,690.

[29] As noted above, we have asked for relief for certain types of advisers that pose no meaningful money laundering risks.

beneficial if advisers were permitted to coordinate (and potentially integrate) any SAR reporting obligations with their qualified custodians. Moreover, to the extent that suspicious activity is detected in a client's account, a lack of coordination among advisers and their qualified custodians could otherwise result in potentially duplicative reporting, costing advisers time and resources without otherwise enhancing the efficacy of anti-money laundering efforts. However, in the absence of clear FinCEN guidance on how these parties may be permitted to coordinate or combine their efforts in carrying out their regulatory responsibilities, we are concerned that the Proposal may yield a system that is needlessly costly (particularly for smaller advisers) and duplicative, and more fragmented, rather than integrated, across the financial industry at large.

V. The Costs of Complying with the Proposal are Potentially Significant

We understand that the cost and time burden for implementing the requirements of the Proposal will vary substantially depending on the size and type of adviser. In this regard, we appreciate FinCEN's risk-tailored approach to AML compliance, which provides advisers flexibility in creating their AML programs and would, in particular, not require smaller advisers to develop complex or cost-intensive AML compliance programs.

That said, IAA believes that the Proposal's cost and time burden estimates severely understate the burden ultimately imposed on advisers under the Proposal. In particular, FinCEN's estimated times for the implementation of an AML program (three hours per year), SAR recordkeeping and reporting (three hours per year) and currency transaction reporting (one hour per cash transaction report ("CTR")) are far too low.[30] If the Proposal is adopted in the form proposed, all advisers will be subject to the significant costs of implementing an AML regime to which they were not previously subject. These costs will naturally be highest at the largest and most complex firms, as even those who have voluntarily implemented an AML program will need to revisit and revise those programs and related computer software to comport with the new rule.[31] Smaller advisers, as noted above, will likely have to outsource the independent testing requirement—a cost that is not addressed in the Proposal—in addition to incurring the overall expense of implementing a new AML program. As a result, compliance costs arising from the Proposal could comprise a substantial portion of a small firm's compliance budget, diverting critical resources away from other risk areas (without materially advancing FinCEN's aims, as noted below). All of this presents a potentially significant burden.

And while costs may be high, as discussed at length in this letter, the AML benefits may be quite limited. Many advisers and advisory activities present little or no meaningful risk of money laundering or terrorist financing, a fact demonstrated by FinCEN's own estimation that each adviser will file only one CTR per year[32] and that smaller advisers will likely file fewer

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[30] *See id.* at 52,698.

[31] While we would expect significant variation among advisers, based on the relative size and complexity of their businesses, we note that a large institutional asset manager with multiple affiliated advisers recently advised us that they estimate spending over 100—and possibly as many as 300—hours, per year, per adviser, on AML compliance under the Proposal.

[32] *See id.* n.111.

than ten SARs per year.[33] That level of reporting—and the correspondingly marginal contribution to our nation's robust AML regime—may not justify its sizeable costs on the adviser industry as a whole.

As FinCEN considers the costs and benefits of this Proposal, it should more carefully consider costs on smaller advisers. The Proposal, in analyzing the impact on small advisers, applies a definition of "small entity" based essentially on having assets under management of less than $25 million—a definition that excludes substantially all of the advisers covered by the proposal.[34] Although we recognize that FinCEN consulted the SEC and the Small Business Administration in doing so, applying that definition is not appropriate in light of the fact that more than half of all SEC-registered advisers are, in fact, small businesses, with fewer than ten non-clerical employees. (Indeed, it is possible that an investment adviser may not be an "entity" at all, but may be a natural person acting as a "sole proprietorship.") By way of contrast, the size standards identified by the Small Business Administration would categorize a company providing "investment advice" as small if it had annual receipts of less than $38.5 million.[35] An adviser with a typical 1% fee structure would have to have $3.85 billion in assets under management to earn $38.5 million in fees. We also observe that, for other industry classifications, the Small Business Administration also employs headcounts as the relevant metric for assessing "small entity" status. However, neither of these factors was considered in selecting the "small entity" definition applied by the Proposal, and as a result, FinCEN readily concluded that the Proposal would not affect a substantial number of small entities. We strongly urge FinCEN to modify its definition of "small entity" to consider the size and complexity of the adviser's operations and staff, not just its assets under management, in order to analyze the true impact of the Proposal.

VI. Implementation Period Should be Extended to Provide a Reasonable Timeframe for Compliance

Under the Proposal, an adviser would be required to implement an AML program compliant with the Proposal on or before six months from the effective date of the final rules. The requirement to file SARs would begin to apply after the adviser's implementation of its AML program.

IAA believes that six months will be insufficient for many advisers to develop compliant AML programs and to put in place the systems, personnel and required disclosures necessary to implement their AML programs and to comply with the suspicious activity monitoring and reporting obligations and recordkeeping requirements set forth in the Proposal. This timeframe is particularly problematic because the Proposal would impose on advisers all of these obligations simultaneously. IAA therefore requests that FinCEN provide a more reasonable

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[33] *See id.* at 52,696.

[34] *See* Proposal, at 52,695 (noting that only an estimated 4% of SEC-registered investment advisers would fall within the SEC's "small entity" definition); *see also* Note 5 above.

[35] *See* 13 C.F.R. § 121.201.

timeframe for compliance to ensure that advisers can fully and effectively satisfy the Proposal's requirements. In this regard, we suggest that an 18-month implementation period may be more appropriate, to provide advisers time to update their operating budgets for the resulting compliance and implementation costs, upgrade and develop internal systems and policies, deliver necessary client disclosures and, where needed, source external service providers to provide independent testing and/or training.

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We truly appreciate your consideration of our comments on this important Proposal. We trust that you will not hesitate to contact us if we may provide any additional information or assistance to you during this process. Please contact me or Paul D. Glenn, IAA Special Counsel, at (202) 293-4222 with any questions regarding these matters.

Respectfully,

/s/

Robert C. Grohowski
General Counsel

cc: The Honorable Mary Jo White, Chair
The Honorable Luis A. Aguilar, Commissioner
The Honorable Kara M. Stein, Commissioner
The Honorable Michael S. Piwowar, Commissioner

David Grim, Director, Division of Investment Management
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Daniel Kahl, Assistant Director, Division of Investment Management