

VIA OVERNIGHT DELIVERY

July 3, 2003

Financial Crimes Enforcement Network
Department of the Treasury
Section 352
Investment Adviser Rule Comments
P.O. Box 39
Vienna, VA 22183

Re: 31 CFR 103 Financial Crimes Enforcement Network; Anti-Money Laundering Programs for Investment Advisers (the "Proposed Rule")

Dear Director Sloan:

The National Society of Compliance Professionals, Inc. ("NSCP") appreciates the opportunity to comment on the rule proposed¹ by the Financial Crimes Enforcement Network ("FinCEN"), Department of the Treasury under Section 352(a) of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001, as amended (the "USA PATRIOT Act"). The Proposed Rule would require certain investment advisers to develop and implement a written anti-money laundering program.

The Proposed Rule is of considerable interest to the NSCP and its members. The NSCP is the largest organization of securities industry professionals devoted exclusively to compliance issues, effective supervision, and oversight. The principal purpose of the NSCP is to enhance compliance in the securities industry, including firms' compliance efforts and programs and to further the education and professionalism of the individuals implementing those efforts. An important mission of the NSCP is to instill in its members the importance of developing and implementing comprehensive compliance programs.

Since its founding in 1987, NSCP has grown to over 1,250 members, and the constituency from which its membership is drawn is unique. NSCP's membership is drawn principally from traditional broker-dealers, investment advisers, bank and insurance affiliated firms, as well as the law firms, accounting firms, and consultants that serve them. The vast majority of NSCP members are compliance and legal personnel, and the asset management members of NSCP span a wide spectrum of firms, including employees from

¹ Prop.Treas.Reg. Sec. 1.103.150; Fed. Reg./Vol.68, No. 86/Mon., May 5, 2003.

the largest brokerage and investment management firms to those operations with only a handful of employees. The diversity of our membership allows the NSCP to represent a large variety of perspectives in the asset management industry.

In general, the NSCP supports the Proposed Rule on anti-money laundering (“AML”) insofar as it would extend to those investment advisers registered with the U.S. Securities and Exchange Commission (“SEC”) under Section 203(a) the U. S. Investment Advisers Act of 1940, as amended (“Advisers Act”) and investment advisers exempt from such registration pursuant to Section 203 (b) (3) of the Advisers Act.² In particular, the NSCP supports FinCEN’s recognition that investment advisers play a variety of roles in financial transactions, some of which raise greater money laundering concerns than do other activities undertaken by advisers. We agree that investment advisers who have custody of client assets pose a higher level of risk than other advisers.³ The NSCP also supports the flexible approach for designing AML programs provided by the Proposed Rule.⁴ The NSCP has consistently advocated that “one size does not fit all” when it comes to regulatory initiatives and proposals which seek to regulate the activities of investment advisory firms.⁵ Nonetheless, the NSCP believes that the effectiveness of the Proposed Rule could be enhanced by clarifying the definition of investment adviser.

The NSCP also supports the extension of the accountholder identification and verification procedures of Section 326 of the USA PATRIOT Act to those investment advisers that have custody of client assets. The NSCP believes that requiring the extension of these procedures beyond such advisers would not further the goal of detecting money laundering and would duplicate information already reported under procedures required for financial institutions under existing rules.

1. Definition of Investment Adviser.

The Proposed Rule defines investment adviser as any person whose principal office and place of business is located in the United States (the “Principal Office Requirement”) and requires that the adviser either be (1) registered or required to be registered with the SEC under section 203(a) of the Advisers Act and reports or is required to report its assets under management (the “AUM Reporting Requirement”); or (2) exempt from registration with the SEC pursuant to section 203 (b)(3) of the Advisers Act (the “Exempt Advisers Requirement”).⁶ Each of these requirements is discussed in more detail below.

² 15 U.S.C. 80b-3(a) and (b)(3).

³ We agree with FinCEN’s conclusion that, “[a]n adviser’s vulnerabilities to money laundering and terrorist financing activity are minimal with respect to clients for whom the adviser does not manage assets.” Proposed Rule at 12). We also agree that “[a]n investment adviser faces the highest degree of vulnerability when clients place or attempt to place assets under management in the form of cash” Proposed Rule at 13, see also Proposed Rule at 8, and text accompanying notes 8-10.

⁴ NSCP supports the clear recognition in the Proposed Rule that each investment adviser should review its own business, types of services it offers, its clients, locations of its offices, whether it maintains custody or not and various other factors in tailoring its AML program to fit its business. Proposed Rule at 11.

⁵ See, e.g., Comment Letter submitted by the NSCP to Proposed Rules: Compliance Programs of Investment Companies and Investment Advisers, Release Nos. IC-25925, IA-2107; File No. S7-03-03, 17 CFR Parts 270 and 275, available at <http://www.sec.gov/rules/proposed/s70303/nscp041703.htm>.

⁶ Proposed Rule §103.150(a).

(a) *The Principal Office Requirement.* The NSCP believes that all investment advisers registered with the SEC should be subject to the substantive requirements of the Proposed Rule, whether or not their principal office and place of business is located in the United States. SEC registration is an important component in the regulatory structure governing investment advisers. If adopted as proposed, investment advisers doing business in the United States would be exempt from U.S. AML requirements merely because they maintained an offshore office as their principal place of business.⁷ To the extent that such foreign registered advisers are soliciting U.S. clients' business and exercising discretion with respect to such assets, failure to include such advisers would leave a gap in the AML regulatory scheme.

The NSCP believes that it is appropriate to consider the laws of foreign jurisdictions in defining the scope of the Proposed Rule, but also believes that a blanket exemption for SEC-registered investment advisers with their principal place of business outside of the U.S. is unnecessary. Moreover, such a broad exemption may actually have the effect of facilitating money laundering activities of such persons. Instead, the NSCP suggests that Section 103.150(a) of the Proposed Rule be amended to provide an exemption from the AML provisions of the USA PATRIOT Act to SEC registered investment advisers with their principal place of business outside of the U.S. if they are subject to the AML rules of a foreign jurisdiction that is not on FinCEN's list of countries whose AML regimes do not meet international standards. Such a provision would close the regulatory gap without over burdening foreign investment advisers. This approach might lead to recognition of the U.S. AML scheme by foreign regulators and further enable SEC registered investment advisers with their principal place of business in the U.S. to more easily operate in these foreign jurisdictions.

(b) *The AUM Reporting Requirement.* Section 103.150(a) (1) of the Proposed Rule contains two elements. First, that an investment adviser be registered, or be required to register with the SEC under the Advisers Act. Second, that the adviser report or be required to report that it has assets under management on Form ADV. With respect to the second requirement, Item 5F of Part 1A of Form ADV requires registered advisers to report assets under management if they "...provide continuous and regular *supervisory or management services* to securities portfolios."⁸ Item 5(b) (3) of the Instructions to ADV Part 1A states that an adviser provides continuous and regular supervisory or management services if either (a) it has discretionary authority⁹ over a client account or (b) responsibility for selecting or making recommendations to the client as to the purchase or sale of specific securities and, if such recommendations are accepted, the adviser is responsible for arranging such purchase or sale. In other words, the underlying substantive requirement for application of the Proposed Rule for SEC registered investment advisers is that the adviser either has investment discretion over client accounts or has responsibility for arranging transactions for clients' accounts.

⁷ Under Rule 203A(c) adopted pursuant to the Advisers Act, principal place of business is defined to include "the executive office of the investment adviser from which the officers, partners, or managers of the investment adviser direct, control, and coordinate the activities of the investment adviser."

⁸ See Form ADV – Uniform Application for Investment Adviser Registration, (Paper Version available at CCH Fed. Sec. L. Rep. ¶ 57,101 (emphasis added).

⁹ Discretionary Authority is further defined in the Glossary to Form ADV to include authority over purchase and sale decisions or decisions on the selection of an adviser to retain on behalf of the client.

The NSCP believes that the Proposed Rule would be more effective if it focused on the substantive business conduct that causes money laundering concerns rather than on the purely procedural requirement to report assets under management to the SEC. Moreover, such an approach would be consistent with the Proposed Rule, which recognizes that investment advisers that neither select securities transactions nor arrange client transactions are not in a position to play a significant role in detecting and combating money laundering.¹⁰ In addition, this approach would be consistent with FinCEN's stated rationale for determining that investment advisers should be covered by the AML provisions of the USA PATRIOT Act:

Many investment advisers provide investment advice to clients who have granted the adviser *the power to manage the assets in their accounts, frequently on a discretionary basis*. As a result, *these investment advisers* engage in activities that “are similar to, related to, or a substitute for” financial services that are provided by other BSA financial institutions.¹¹

(c) *The Exempt Advisers Requirement*. The NSCP supports FinCEN's inclusion in the Proposed Rule of investment advisers exempt from registration under the Advisers Act by Section 203(b) (3). However, the NSCP believes that such advisers should only be covered by the Proposed Rule if they are engaged in the substantive business conduct that causes money-laundering concerns. In other words, advisers that are exempt from registration under Section 203(b) (3) should only be required to comply with the AML provisions of the USA PATRIOT Act if they either have investment discretion over client accounts or responsibility for arranging transactions for client accounts. Inclusion of advisers who do not perform such services would be inconsistent with the purposes of the USA PATRIOT Act and an unnecessary burden to many smaller advisers.

We further note that, under Section 5312 of the Bank Secrecy Act (“BSA”), as amended by the USA PATRIOT Act, investment advisers are not enumerated among the entities defined as financial institutions. While Section 5312 of the BSA gives the Secretary of the Treasury authority to include additional entities in this definition, the Secretary may do so only if he/she determines that an entity is engaged in an activity “which is similar to, related to, or a substitute for any activity in which any business described in this paragraph is authorized to engage; ...”¹² As pointed out above, FinCEN's stated rationale for determining that investment advisers should be subject to the USA PATRIOT Act is that clients grant advisers the power to manage the assets in their accounts. The Proposed Rule recognizes that the term “manage” must include some active control over client assets.¹³ The Proposed Rule also acknowledges the centrality of this ability to control the disposition of client assets in limiting the definition of investment adviser for SEC registered entities to those entities that report or are required to report their assets under management on Form ADV. As noted above, this obligation only exists for investment advisers

¹⁰ See Proposed Rule, note 14 and accompanying text.

¹¹ See, Proposed Rule, text accompanying note 5 (emphasis added).

¹² BSA Sec. 5312(a) (2) (Y).

¹³ For example, the Proposed Rule notes that advisers that manage assets engage in a business related to other financial institutions because they “work so closely with other BSA financial institutions – such as by directing broker-dealers to purchase or sell client securities or by directing banks to transfer client funds” Similarly, the business of advisers may be a substitute for the services offered by these other institutions because clients choose to have advisers manage their assets in pooled form or other forms that compete with management services offered by such institutions. See Proposed Rule, text accompanying note 5.

that either have investment discretion over client accounts or that have responsibility for arranging transactions for clients' accounts.

For these reasons, the NSCP believes that to the extent that Section 103.150(a) (2) includes unregistered investment advisers that do not manage client assets, it is inconsistent and not in accordance with the provisions set forth in Section 5312 (a) (2) (Y) of the BSA. Accordingly, NSCP recommends that the section be revised to apply to only those advisers who are not registered with the SEC in reliance on Section 203(b) (3) who have (a) discretionary authority over a client account or (b) responsibility for selecting or making recommendations to the client as to the purchase or sale of specific securities and, if such recommendations are accepted, the adviser is responsible for arranging such purchase or sale.

2. Suspicious Activity Reports

Although not part of the Proposed Rule, FinCEN has requested comments on whether investment advisers should be required to file suspicious activity reports pursuant to BSA Section 5318(g) ("SARS") and complying with accountholder identification and verification procedures pursuant to BSA Section 326 ("Verification"). The NSCP supports the extension of SARS and Verification to those investment advisers that have custody¹⁴ of client assets because these investment advisers are in a position to take notice of deposits to and withdrawals from clients' accounts. However, the NSCP believes that extending these requirements beyond such advisers would be of little benefit and would duplicate the procedures already adopted by financial institutions under existing rules.

As stated in the Proposed Rule, "advisers rarely hold financial assets themselves and even more rarely accept cash . . ." ¹⁵ An investment adviser that does not have custody of its clients' funds would not generally be aware of account activity, including deposits into and withdrawals from the clients' accounts. Unless the adviser is the sole manager of the clients' assets, it would not be in a position to know, much less monitor for, frequent or unusual activity. Without such a general overview of client transactions, advisers would not be in a position to recognize specific transactions as being suspicious.

FinCEN explicitly recognized the limited role played by advisers who do not have custody of client assets.¹⁶ The insignificance of the role played by these investment advisers accounts, in part, for the limited number of reported instances of structuring, layering and integration actually cited by FinCEN.¹⁷ Moreover, FinCEN has recognized that where an investment adviser does not have custody of client funds, "[s]ecurities account custodians typically handle the actual deposit and withdrawal of funds in a client's account. In most cases, these custodians are broker-dealers, banks, or other entities that are 'financial institutions' under FinCEN's BSA rules." Accordingly, except where an investment adviser has custody of a client's assets, FinCEN's existing BSA

¹⁴ For this purpose, custody includes circumstances where an investment adviser selects and retains the custodian for or on behalf of the client.

¹⁵ See Proposed Rule, text accompanying note 9.

¹⁶ See Proposed Rule, text accompanying note 15.

¹⁷ See Proposed Rule, text accompanying notes 6-7 ("some instances" related to structuring, one instance of layering and no reported instances of integration). The Proposed Rule does not disclose whether these instances were reported by investment advisers, other financial service companies, or both.

rules already ensure that Verification procedures are in place and that FinCEN will receive SARS in appropriate circumstances. Requiring that investment advisers who do not have custody of client assets to adopt Verification procedures and to file SARS will not enhance existing controls or add to the information currently supplied to FinCEN through SARS. Extending the SARS and Verifications requirements to such investment advisers will, however, result in overlapping and duplicative reporting and increase the burden on investment advisers, as well as FinCEN. For these reasons the NSCP does not believe that extending the SARS and Verification requirements to investment advisers is warranted unless the investment adviser has custody of client assets.

3. Conclusion

NSCP supports the Proposed Rule, but believes the definition of who is included within the ambit of an “investment adviser” should be enhanced to include all investment advisers registered with the SEC whether or not their principal place of business is outside the United States unless such advisers are subject to the AML rules of a foreign jurisdiction that is not on FinCEN’s list of countries whose AML regimes do not meet existing international standards. NSCP also believes that the definition of investment adviser would be enhanced by including only those advisers (whether registered with the SEC or exempt from such registration under Section 203(b) (3) of the Advisers Act) that either have investment discretion over client accounts or that have responsibility for arranging transactions for clients accounts.

The NSCP does not support extending the SARS and Verification requirements of FinCEN’s BSA Rules to investment advisers who do not have custody of client assets. FinCEN is guided by the overriding goal of not imposing overlapping or duplicative regulation on investment advisers and other financial institutions that are subject to AML programs. The NSCP believes that the proposed extension of the SARS and Verification requirements would have precisely this result, but would not enhance the information currently available to FinCEN or improve FinCEN’s ability to detect and combat money laundering activity. It is in the consideration of this goal and the further reasons set forth above that NSCP does not believe or support the application of SARS and Verification to investment advisers.

Questions regarding our comments or requests for additional information should be directed to the undersigned at 860.672.0843.

Sincerely yours,

Joan Hinchman
Executive Director, President and CEO