

#### IV. Section-by-Section Analysis

##### A. Definition of Investment Adviser for Purposes of the Proposed Rule

The SEC regulates investment advisers under the Advisers Act. The proposed rule relies on terms and definitions used by the Advisers Act and in the SEC's regulations to define the scope of the rule.<sup>12</sup> Section 103.150(a) of the proposed rule defines two groups of advisers located within the United States required to have anti-money laundering programs.

The first group consists of advisers that (i) have a principal office and place of business in the U.S. (U.S. advisers), (ii) are registered with the SEC, and (iii) report to the SEC that they have assets under management.<sup>13</sup> This group includes advisers registered with the SEC that have either discretionary or non-discretionary authority to manage client assets.<sup>14</sup> It excludes, however, advisers that are not registered with the SEC because they are smaller, state-registered firms that have less than \$30 million of assets under management, as well as advisers that are registered with the SEC but do not manage client assets.<sup>15</sup> Because these excluded firms, unlike many "financial institutions" such as banks or broker-dealers, do not accept funds or hold financial assets directly, and have relatively few (or no) assets under management, these firms

markets while avoiding detection by banks, broker-dealers, mutual funds, and other financial institutions that have adopted programs.

<sup>12</sup> This approach would permit advisers to determine easily whether they are subject to the proposed rule, and would permit both Treasury and the SEC to identify which advisers have obligations under the proposed rule.

<sup>13</sup> SEC-registered advisers report their assets under management in Part 1A of Form ADV (17 CFR 279.1), which is the investment adviser registration form. The item currently requiring this information is Item 5.F of Part 1A.

<sup>14</sup> When a client places its assets with an advisory firm for management, the client authorizes the advisory firm to buy or sell securities for the client's account, and the account itself is maintained with a broker-dealer, bank, or other custodian. However, many advisory firms, such as financial planners or pension consultants, do not manage clients' assets. While these investment advisers may recommend securities or asset allocations, their clients make their own arrangements to purchase and sell securities; in some cases, the adviser may not be told whether the client has acted on the firm's advice.

<sup>15</sup> Section 203A of the Advisers Act generally prohibits advisers with assets under management of less than \$25 million from registering with the SEC. Primary responsibility for regulating these firms rests with state securities authorities. Under SEC rules, however, firms with between \$25 and \$30 million in assets under management may choose whether to register with the SEC or with the states, and certain other investment advisers—such as certain pension consultants—register with the SEC even though they may not manage \$25 million in assets. 17 CFR 275.203A-1; 17 CFR 275.203A-2.

are unlikely to play a significant role in money laundering.

The second group consists of U.S. advisers that are *not* registered with the SEC, but have \$30 million or more of assets under management and are relying on the registration exemption provided by section 203(b)(3) of the Advisers Act (15 U.S.C. 80b-3(b)(3)) (unregistered advisers). Under section 203(b)(3), advisers that have fewer than 15 clients and do not hold themselves out generally to the public as investment advisers are exempted from SEC registration.<sup>16</sup> Many of the advisers that use this registration exemption may control substantial client assets, either because they have a few individual clients with very large accounts or because they advise certain types of pooled investment vehicles, such as limited partnerships.<sup>17</sup>

With respect to this second group of investment advisers, the proposed rule would exclude those entities that would qualify as unregistered advisers but that are otherwise required to have an anti-money laundering program under the BSA because they are dually registered as a financial institution in another capacity and are examined by a Federal functional regulator for compliance with the requirement in that other capacity.<sup>18</sup> This explicit exclusion will avoid potential duplicative anti-money laundering regulation of these financial institutions by the SEC and other Federal functional regulators and promote the efficient allocation of scarce government resources.

In some instances, investment advisers that would be subject to the

<sup>16</sup> Section 203(b)(3) exempts from registration any investment adviser who during the course of the preceding 12 months has had fewer than 15 clients and who neither holds himself out generally to the public as an investment adviser nor acts as an investment adviser to any registered investment company or business development company that has elected to be regulated as such.

<sup>17</sup> An SEC rule permits the adviser to count the partnership or other pooled investment vehicle as a single client, rather than count each limited partner or other investor as a client. 17 CFR 275.203(b)(3)-1. As a result, the adviser may have only one or two pooled investment vehicle clients, yet manage tens or hundreds of millions of dollars. While some of these pooled investment vehicles may be subject to FinCEN's proposed rule requiring unregistered investment companies to implement anti-money laundering programs, these advisers may have other clients not subject to that rule. See *Anti-Money Laundering Programs for Unregistered Investment Companies*, 67 FR 60617 (Sept. 26, 2002) (UIC NPRM).

<sup>18</sup> For example, as noted above, FinCEN is proposing today a similar rule for commodity trading advisers. FinCEN is also considering requiring that commodity pool operators (which are also BSA financial institutions subject to regulation by the CFTC) establish and implement the anti-money laundering programs required pursuant to the UIC NPRM, *supra* note 17, for commodity pools that they operate.

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.<sup>19</sup> 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.

##### B. The Anti-Money Laundering Programs

###### 1. Individualized Program

Section 103.150(b) of the proposed rule would require each investment adviser subject to the proposed rule to develop and implement its own anti-money laundering program reasonably designed to prevent the firm from being used to launder money or finance terrorist activities and to achieve and monitor compliance with the other applicable requirements of the BSA and FinCEN's implementing regulations. Every program must incorporate four minimum requirements, discussed below, but each adviser will tailor its program to address the risks presented by the nature of its services and clients. In addition, each adviser may implement its program in a manner reasonably practicable in light of the firm's size and resources. For example, according to recent information filed by the approximately 7,750 investment advisers registered with the SEC, only ten percent of them reported that their firms had more than 50 employees, whereas nearly half reported having one to five employees. While FinCEN expects that large firms will adopt detailed procedures addressing the responsibilities of the individuals and departments involved in carrying out each aspect of the program, smaller firms may adopt procedures consistent

<sup>19</sup> For example, an investment adviser may be adviser to a mutual fund, or adviser to a bank's common or collective trust fund. BSA rules obligate mutual funds and banks to maintain anti-money laundering programs to protect against attempted money laundering by their customers. *Anti-Money Laundering Programs for Mutual Funds*, 67 FR 21117 (April 29, 2002); *Anti-Money Laundering Programs for Financial Institutions*, 67 FR 21110 (April 29, 2002). An adviser may also act as adviser to other investment pools, such as an insurance company's separate accounts or certain unregistered investment companies, that will be similarly subject to anti-money laundering program rules under pending FinCEN proposals. See, e.g., *Anti-Money Laundering Programs for Insurance Companies*, 67 FR 60625 (Sept. 26, 2002); UIC NPRM, *supra* note 17.