

with their simpler, centralized organizational structure.²⁰

To assure that the requirement to have an anti-money laundering program receives the highest level of attention, the proposed rule would require that each investment adviser's program be approved in writing by the board of directors or trustees or, if it doesn't have one, by its sole proprietor, general partner, or other persons who have similar functions.²¹ The four required elements of the anti-money laundering program are discussed below.

2. The Four Required Elements of Each Anti-Money Laundering Program

(1) *Establish and Implement Policies, Procedures, and Internal Controls Reasonably Designed to Prevent the Investment Adviser From Being Used to Launder Money or Finance Terrorist Activities, Including but not Limited to Achieving Compliance with Applicable Provisions of the BSA and FinCEN's Implementing Regulations.*

Each investment adviser subject to the proposed rule would be required to develop a written program reasonably designed to prevent the firm from being used to launder money or finance terrorist activities and to achieve compliance with applicable requirements of the BSA and FinCEN's implementing regulations. As described below, this would require each investment adviser to review the types of services it provides and the nature of its clients to identify its vulnerabilities to money laundering and terrorist financing activity. The adviser would then develop and implement procedures and controls that would reasonably address each vulnerability and assure compliance with these requirements, and periodically assess the effectiveness of its procedures and controls.

An adviser's vulnerabilities to money laundering and terrorist financing

activity are minimal with respect to clients for whom the adviser does not manage assets. Many advisers that manage portfolios for some clients have other clients to whom the firm provides very different services, such as pension consulting, securities newsletters or research reports, or financial planning. Accordingly, in designing its anti-money laundering procedures, an adviser could exclude clients for whom the firm does not manage assets.

Advisers face higher vulnerability to money laundering when clients place their assets under management with the firm. An adviser's procedures for these clients would seek to identify unusual transactions whereby clients place funds under the firm's management through checks drawn on (or wire transfers made from) accounts of third parties with no family or business relationship to the client, or through numerous checks or transfers from one or more issuers or institutions. In addition, an adviser's procedures would identify unusual transactions upon the subsequent withdrawal of assets from management with the firm, such as payments in numerous separate monetary instruments, transfers to unrelated or numerous accounts,²² or to accounts in countries in which drugs are known to be produced or other countries at high-risk for money laundering or terrorist financing.²³

An adviser's vulnerability rises further with respect to clients who make frequent additions to or withdrawals from their advisory accounts with the firm. An adviser would need to establish procedures to identify which clients engage in such activity, and assess the reasonableness of the additions or withdrawals in light of the clients' investment objectives and the firm's existing knowledge of the clients'

personal finances or business operations.

An investment adviser faces the highest degree of vulnerability when clients place or attempt to place assets under management in the form of cash, or require investment options or brokerage, banking, or other custodial arrangements that allow the client to remain anonymous to other intermediaries. The adviser would need to establish procedures to assess whether there are legitimate circumstances underlying the client's request before proceeding with the relationship.

An adviser's program should also take into account the extent to which the adviser provides investment advice to, and creates or administers, pooled investment vehicles, as well as whether the adviser provides advice to pooled investment vehicles that are created and administered by the adviser or by a third party. As discussed above, investment advisers to pooled investment vehicles that are subject to anti-money laundering program requirements under BSA rules may exclude the vehicles from their anti-money laundering programs. However, an investment adviser must include other pooled vehicles it advises in its anti-money laundering program, using different approaches depending on whether the adviser is also the entity creating or administering the pooled vehicle.

Advisers providing investment advice to pooled investment vehicles that are not subject to BSA anti-money laundering requirements, and that are created and administered by a third party, would have little or no information about the investors in the pooled vehicle or their transactions. In this situation, the adviser would need to establish procedures to assess whether the entity that created and administers the vehicle, or the nature of the vehicle itself, reduces the risk of money laundering. For example, an employee retirement savings plan sponsored by a public corporation that accepts assets only in the form of payroll deductions or rollovers from other similar plans presents no realistic opportunity for money laundering activity, whereas an offshore vehicle not itself subject to any anti-money laundering program requirement would present a more significant risk. The adviser's program would need to analyze the money laundering risks posed by a particular investment vehicle by using a risk-based evaluation of relevant factors including: the type of entity; its location; the statutory and regulatory regime of that location (e.g., if the entity is organized

²⁰ The legislative history of the Act reflects that Congress intended that each financial institution should have the flexibility to tailor its program to fit its business, taking into account factors such as size, location, activities, and risks or vulnerabilities to money laundering, so long as the program meets the four minimum statutory requirements. This flexibility is designed to ensure that all firms subject to the Act, from the largest to the smallest, have in place policies and procedures appropriate to monitor for money laundering. See USA PATRIOT Act of 2001: Consideration of H.R. 3162 Before the Senate, 147 Cong. Rec. S10990-02 (October 25, 2001) (statement of Sen. Sarbanes); Financial Anti-Terrorism Act of 2001: Consideration Under Suspension of Rules of H.R. 3004 Before the House of Representatives, 147 Cong. Rec. H6938-39 (October 17, 2001) (statement of Rep. Kelly) (provisions of the Financial Anti-Terrorism Act of 2001 were incorporated as Title III in the Act).

²¹ The board's approval could be given at its first regularly scheduled meeting after the program is adopted.

²² Securities 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. Commonly, the client selects and contracts for account services with the custodian and instructs the custodian to permit the adviser to trade securities in the account. In such cases, the custodian's personnel may have exclusive access to the information needed to assess whether the source or destination of funds transfers in and out of the account are unusual. If the adviser selects and retains the account custodian, however, the adviser should coordinate review of these transactions with the custodian, as is discussed in connection with service providers, below.

²³ See, e.g., <http://www.state.gov> for International Narcotics Control Reports evaluating the effectiveness of countries' controls against narcotics trafficking and for lists of state sponsors of terrorism, and <http://www.fincen.gov> for FinCEN Advisories identifying countries whose anti-money laundering regimes do not meet international standards.