ADISA
ALTERNATIVE & DIRECT INVESTMENT SECURITIES ASSOCIATION
Education ▲ Networking ▲ Advocacy

450 E. 96th Street
Suite 185
Indianapolis, IN 46240

317-663-4180 *main*
www.adisa.org

July 22, 2024

VIA ELECTRONIC SUBMISSION

Ms. Vanessa A. Countryman
Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090

Financial Crimes Enforcement Network
U.S. Treasury Department
P.O. Box 39
Vienna, VA 22183

RE: Proposed Rule on Customer Identification Programs for Registered Investment Advisers and Exempt Reporting Advisers (SEC File No. S7-2024-02; FinCEN Docket No. 2024-0011)

Dear Ms. Countryman and FinCEN Policy Division:

The Alternative & Direct Investment Securities Association ("ADISA"),[1] a member association focused on alternative investments, appreciates the opportunity to comment on the proposal (the "Proposal") by the U.S. Securities and Exchange Commission ("SEC") and the U.S. Treasury's Financial Crimes Enforcement Network ("FinCEN") to effectively require investment advisers registered with the SEC, as well as so-called "exempt reporting advisers," to adopt customer identification procedures ("CIPs"). The Proposal follows FinCEN's earlier proposal to designate certain investment advisers as "financial institutions" under the Bank Secrecy Act ("BSA") and subject them *inter alia* to anti-money laundering and countering the financing of terrorism program requirements as well as suspicious activity report ("SAR") filing obligations.

## ADISA

ADISA's membership includes advisers registered with the SEC under the Investment Advisers Act of 1040, as amended (the "Advises Act"), as well as State registered investment advisers, broker-dealers, and firms that sponsor, manage and distribute various alternative investments, including private funds. ADISA members generally focus on alternative investments made available in the retail and accredited investor spaces. As a broad-based member association, ADISA seeks to engage in productive dialogue with legislators and regulators with oversight of its members'

[1] ADISA is the largest association of the retail direct investment industry in the United States. ADISA has approximately 5,000 members who employ over 220,000 investment professionals, together serving the interests of more than 2 million investors throughout the country. Direct and alternative investment programs serve a critical need in the creation and ongoing management of diversified investment portfolios.

activities, with the goal of providing objective information about the marketplace for alternative investments.

## Comments

### A. Background

Much of the Proposal rests on the Department of the Treasury's 2024 Investment Adviser Risk Assessment (the "Assessment"). To summarize the conclusions drawn on in the Assessment, the Treasury Department concluded earlier this year that "the highest illicit finance risk in the investment adviser sector is among ERAs (who advise private funds exempt from SEC registration), followed by RIAs who advise private funds, and then RIAs who are not dually registered as, or affiliated with, a broker-dealer (or is, or affiliated with, a bank)."[2] The three main areas of concern identified in the assessment are: (i) Laundering of Illicit Proceeds Through Investment Advisers and Private Funds; (ii) Russian Political and Economic Elites' Access to U.S. Investments; and (iii) Foreign State Actors That Could Use Investment Funds to Access Critical Infrastructure or Sensitive Technologies.[3]

According to the Assessment, the "mechanisms for laundering illicit proceeds through investment advisers and private funds vary, but generally consist of obscuring the illicit origins of funds and pooling them with legitimate funds to invest in U.S. securities, real estate, or other assets." The Assessment mentions the possibility that "the investment adviser or other financial professional may form a private fund through which illicit proceeds can be transferred as part of a money laundering scheme." The Assessment further notes that "an investment adviser may be unwittingly complicit in this type of activity if they are not required to understand the origin of funds or nature of their owner."

### B. Specific Comments

ADISA is supportive of regulatory initiatives designed to facilitate the prevention, detection, and prosecution of international money laundering and the financing of terrorism. From its perspective, however, ADISA believes that certain aspects of the Proposal are unnecessarily broad and burdensome and, potentially, imprecise and unworkable. In some cases, the Proposal simply is not drafted to address the issues that the Assessment identifies as critical threats when discussing the need to impose AML and CIP programs on investment advisers. In other words, the Proposal would reach relationships that simply do not pose the "entry risk" elements that the Assessments and the Proposal identify as critical vulnerabilities, as those relationships do not provide the access to the capital markets that is at the heart of the Assessment's threat analysis. Finally, the Proposal creates a basis for allowing an advisory firm to delegate their responsibilities to other parties, but in doing so ignore the structures for AML and related testing, etc. that already exist inside most private

---

[2] According to the Assessment, "private funds advised by RIAs, such as hedge and private equity funds, as well as venture capital funds, held approximately $20 trillion in assets under management (AUM) as of Q4 2022, and have limited reporting obligations under the federal securities laws."

[3] The Assessment also notes that "advisers (RIAs, ERAs, and state-registered advisers) have defrauded their clients and stolen their funds," but it is hard to understand how this element ties either to AML or to CIP requirements. All fraud committed by advisers is unwarranted, but it is hard to see how a program to better identify advisory clients will lead to a diminution in fraudulent activity by advisers.

fund structures and makes delegation, as far as it is proposed, very difficult to set up and/or maintain.

The most important aspects of the Proposal are, in our opinion, two-fold: the proposed reach of the CIP program requirements to all advisory accounts opened by covered firms, including both private funds managed or advised by an advisory firm or its affiliate(s) as well as advisory relationships that do not involve the custody of funds or other assets; and the ability of an advisory firm to delegate to others its duties under the proposed CIP requirements. We address these points in turn below.

i. Reach of Proposed Definition of "Account"

As stated above, the reach of the proposed CIP requirements is very broad, in no small part because of the definition of "account" and "customer." The Proposal would define "account" for the purposes of an adviser's CIP obligations as "any contractual or other business relationship between a person and an investment adviser under which the investment adviser provides investment advisory services."[4]

The Proposal's definition of account makes clear that advisers would be required to perform CIP duties on the private funds that they manage or advise, but not on the investors in such funds. Advisers to funds, including private funds, do not typically enter into agreements directly with investors in the pooled vehicles but instead enter into an advisory agreement directly with the pooled vehicle. While some commentators have suggested that prudent advisory firms will also perform CIP on investors int the private funds themselves, the absence of a requirement to do so means that CIP programs will not be applied to the types of investors that the Assessment was focused on - to wit, money launderers as well as non-US governmental entities that are believed to be seeking other benefits potentially available through investment in the funds that the advisory firms manage.

In addition to this structural deficiency, the definition of accounts is not nuanced and does not distinguish between accounts that are funded by clients and introduce money into the US and global financial systems, and those accounts that merely provide the advisory firm with discretionary authority over funds or assets that are already present in the US or global financial system. Investment advisers that do not take custody of client assets or whose services do not provide access to financial markets do not pose the risk of money laundering or terrorism financing as described in the Proposal. The Proposal would require investment advisers' CIPs to apply to all customers, regardless of whether the investment advisory services facilitate the activities the Proposal is designed to address (and that were singled out in the Assessment). Many investment advisers do not offer accounts where customers can hold funds or securities or facilitate the type

[4] According to the Proposal, the definition of account would include accounts opened for the purpose of participating in an employee benefit plan established pursuant to the Employee Retirement Income Security Act of 1974 ("ERISA"). Those accounts are not being excluded from the Proposal to "harmonize the applicability of the proposed rule with the AML and SAR requirements, which were separately proposed earlier this year by FinCEN." In addition, the proposed definition excludes an account that an investment adviser acquires through an acquisition, merger, purchase of assets, or assumption of liabilities, on the grounds that customers do not "open" such accounts.

of money laundering or terrorism financing described in this Proposal; nevertheless, the Proposal would require all investment advisers to implement a CIP.

ADISA does not believe that the SEC and FinCEN have explained the benefits associated with implementing and applying a CIP to the types of investment advisory firms that do not facilitate the activities the Assessment and this Proposal are focused on. The Proposal acknowledges that "the benefits of the proposed rule would also be lessened to the extent that an investment adviser's customer holds accounts for purposes other than accessing financial markets (for example, if the customer holds an account only to receive investment research services)." The Proposal then caveats that statement with a footnote reading "however, these services could also be used to facilitate other aspects of the money laundering process."

ADISA does not understand how an investment adviser providing advice could facilitate the illicit activities identified in the Assessment and described in the Proposal. Although the Proposal would allow for a risk-based assessment of a customer, it does not permit advisers to distinguish among investment advisory services that may facilitate money laundering and other illicit activities, and investment advisory services that do not. ADISA does not believe that the SEC and FinCEN have supplied sufficient evidence on why any advisory business that does not hold assets or process transactions should be covered under this Proposal.

For this reason, ADISA recommends that the SEC and FinCEN exclude from any requirement that investment advisers have CIPs those advisory services that do not provide access to financial markets. Such activities do not represent the type of exposure to facilitating money laundering or terrorism financing the Proposal is designed to mitigate. This exclusion could also be accomplished by excluding from the definition of Customer those customers to whom the investment adviser does not provide custody services or access to financial markets.

Finally, touching on a point that is also discussed under Delegation, below, the Proposal would allow investment advisers to deem the requirements satisfied for any mutual fund it advises if the mutual fund has developed and implemented a CIP that is compliant with CIP requirements applicable to mutual funds under regulations previously adopted by FinCEN. The release accompanying the Proposal states that this exemption "is appropriate because of the regulatory and practical relationship between mutual funds and their investment advisers," and that "as a practical matter... any CIP requirement imposed on an RIA [with regard to] a mutual fund is already addressed by the existing CIP requirements imposed on the mutual fund itself."

While ADISA welcomes this position as applied to open-end funds that operate as mutual funds, the Proposal excludes closed-end funds from this exemption and does not extend the concept of "duplication of regulatory effort and regime" to that part of the fund industry nor does it do so with regard to the private fund world. While, as noted above, the CIP requirement would apply to the vehicle itself and not to investors therein, closed-end funds that are not exchange-listed utilize much of the same direct investor framework that applies in the mutual fund space.[5] To the extent that a closed-end fund or a private fund adopts a CIP for its operations that is compatible with the

[5] Exchange-listed closed-end funds and open-end funds that operate as exchange traded funds (or ETFs) are typically held in brokerage or custody accounts, which would generally be subject to AML and CIP rules imposed on banks and broker-dealers.

FinCEN regime applicable to mutual funds, advisers to such funds should be able to exclude those funds in the same manner that they are able to exclude qualifying mutual funds from their CIP operations.

ii. Delegation

The Proposal would permit an adviser to rely on another financial institution to perform its CIP requirements, provided that it complies with requirements to actively monitor the operation of its CIP and assess its effectiveness in order to rely on another financial institution, as well as to enter into an agreement with the third party covering the delegation.[6] The investment adviser would remain responsible, however, for ensuring compliance with the proposed rule and would not be held responsible for the failure of the other financial institution to fulfill adequately the adviser's CIP responsibilities only if it can establish that its reliance was reasonable and that it obtained the requisite contracts and certifications.[7]

ADISA submits that the delegation approach spelled out in the Proposal both requires more from the adviser than is necessary and overlooks the applicability of the approach taken with regard to mutual funds. Many private funds, both in the U.S. and offshore, employ custodians to receive and hold fund assets and utilize subscription or transfer agents that process subscriptions and redemptions (and transfers). Both the custodian banks and the subscription/transfer agents are often subject to the requirements of the BSA and thus employ both AML and CIP policies in regard to investors in the funds. In our opinion, the SEC and FinCEN should attempt to create a notion of delegation that picks up on these elements and allows advisers to closed-end funds and private funds to deem them to be in compliance with their own CIP (and AML) requirements where the agents for those funds have and apply AML and CIP regimes that are compatible with and/or satisfy the requirements appliable to other parties under the BSA.

## Conclusion

At bottom, the Proposal would impose significant costs on investment advisers without unnecessarily advancing the goals of the Assessment. ADISA does not believe that the SEC and FinCEN have supplied sufficient evidence on why advisory businesses that do not hold assets should be covered under this Proposal, have articulated the benefit to be gained from having CIPs

---

[6] Proposed § 1032.220(a)(6) would provide that an investment adviser's CIP may include procedures that specify when the investment adviser may rely on the performance by another financial institution (including an affiliate) of any procedures of the investment adviser's CIP, and thereby satisfy the investment adviser's obligations under the proposed rule. As proposed, reliance would be permitted only if such reliance is reasonable under the circumstances, the other financial institution is subject to a rule implementing the AML/CFT compliance program requirements of 31 U.S.C. 5318(h) and is regulated by a Federal functional regulator, and the other financial institution enters into a contract with the investment adviser requiring it to certify annually to the investment adviser that it has implemented an AML/CFT program and will perform (or its agent will perform) the specified requirements of the investment adviser's CIP.

[7] As stated by the SEC and FinCEN, the investment adviser and the other financial institution upon which it relies would have to satisfy all of the conditions set forth in this proposed rule and, if they do not, the investment adviser would remain solely responsible for applying its own CIP to each customer in accordance with this rule.

applied to accounts that are private funds or non-custodial in nature, or have justified an overbroad and overly exacting approach to delegation.

ADISA appreciates the opportunity to present its perspective and views on the SEC's and FinCEN's Proposal. Should you have any questions about this letter or wish to discuss the points made herein in greater detail, please do not hesitate to contact us.

Sincerely,

Jade Miller
President

cc: ADISA Drafting Committee and Legislative and Regulatory Committee Co-chairs, John H. Grady, Catherine Bowman