November 2, 2015

Financial Crimes Enforcement Network (FinCEN)
U.S. Department of the Treasury
P.O. Box 39
Vienna, VA 22183

Re: Anti-Money Laundering Program and Suspicious Activity Report
Filing Requirements for Registered Investment Advisers (RIN: 1506-AB10)

Dear Sir or Madam:

On September 1, 2015, the Financial Crimes Enforcement Network ("FinCEN") published in the Federal Register a re-proposal of its rule to newly require SEC-registered investment advisers to create anti-money laundering ("AML") compliance programs and to file suspicious activity reports ("SARs") ("Proposed Rule").\(^1\) The Proposed Rule is the latest attempt by FinCEN to create AML program and SAR filing requirements for SEC-registered advisers, with the first proposed regulations being issued May 2003.\(^2\) The 2003 proposal was withdrawn in 2008\(^3\), with FinCEN recognizing that it needed to further study this issue before proceeding with further rulemaking.

The Small Business Investor Alliance ("SBIA") appreciates the opportunity to comment on the Proposed Rule and provide our feedback on how it negatively impacts SEC-registered advisers to private funds investing in small business. SBIA is a national association that develops, supports, and advocates on behalf of policies that benefit investments funds that finance small and mid-size businesses in the lower middle market and middle market, as well as the investors that provide capital to these funds. Our membership consists of traditional 3(c)(1) and 3(c)(7) private funds and their advisers, funds registered as business development companies ("BDCs") under the Investment Company Act of 1940, funds that have been licensed or are seeking to be licensed by the Small Business Administration ("SBA") as small business investment companies ("SBICs") and their advisers, and the investors that invest in these funds, including high

\(^1\) Anti-Money Laundering Program and Suspicious Activity Report Filing Requirements for Registered Investment Advisers, 80 Fed. Reg. 52680-52701 (September 1, 2015).
\(^3\) Withdrawal of the Notice of Proposed Rulemaking; Anti-Money Laundering Programs for Investment Advisers, 73 Fed. Reg. 65,568 (Nov. 4, 2008).
net worth individuals, banks, family offices and pension funds.\textsuperscript{4} Many of our members are SEC-registered investment advisers that advise smaller private equity funds and SBICs and would come under the purview of the Proposed Rule.

1. SEC-Registered Advisers to 3(c)(1) or 3(c)(7) funds Present Little Risk of Money Laundering Due to Their Illiquid Nature

Small private equity funds and their advisers, including SBIA’s members, present little risk for of money laundering or terrorism finance. Investments in private equity funds are long-term, illiquid investments. Typically, private equity funds have a life span of ten years or more. At the time of fund formation, investors, or limited partners (“LPs”) in the fund subscribe for capital commitments which are subsequently “called” by the investment adviser (often the general partner or “GP” of the fund), generally over the first five years of the fund, which is known as the “investment period.” These “capital calls” are drawn from time to time to fund the investment activities and expenses of the fund and its adviser. During the later years of the fund’s life, known as the “harvest period”, the fund is returning distributions from its underlying investments, assuming these are profitable. As a result, LPs in private equity funds \textit{have no redemption or withdrawal rights}, and are generally unaware of when or if they will receive returns from their investment in the fund. The lack of liquidity presented in the private equity funds is an inherent feature of the investment, and is less attractive to those laundering money. Other, more liquid investments present more effective tools for money laundering by providing quick access to the invested funds.

FinCEN has recognized the lack of attractiveness for money laundering presented by private equity funds in previous rulemakings. In September 2002, FinCEN released a proposed exemption, later withdrawn, which amended the Bank Secrecy Act to prescribe minimum standards applicable to certain unregistered investment companies, such as hedge funds, commodity pools and similar investment vehicles.\textsuperscript{5} However, in the definition proposed in this proposed rulemaking, FinCEN pointed out that that: “[investment] companies that offer interests that are not redeemable or that are redeemable only after a lengthy holding or “lock-up” period lack the liquidity that makes certain financial institutions attractive to money launderers in the first place...[t]his ‘redeemability’ requirement is likely to exclude...entities that require lengthy investment periods without the ability to redeem assets, including...many private equity and venture capital funds. These types of illiquid companies are \textit{not likely to be used by money launderers.}\textsuperscript{6} While retail investment advisers may present some risk of money laundering to small businesses due to the significant amount of currency moving within

\textsuperscript{4} SBIA currently represents over 200 individual fund advisers, including over fifty percent of BDCs currently in the marketplace.
\textsuperscript{5} Anti-Money Laundering Programs for Unregistered Investment Companies, 67 Fed. Reg. 60,617 (September 26, 2002).
\textsuperscript{6} \textit{Id.} at 60,619 (emphasis added).
the adviser, advisers to private equity funds, like SBIA’s members, pose little risk due to
the illiquid nature of their funds.

While FinCEN points out the existence of the previous proposed rules in the Proposed
Rule draft, they fail to explain why the agency’s position has changed on the low money
laundering risk presented by registered advisers to private equity funds. Instead, the
Proposed Rule merely states that “the two pronged approach of the prior approach is no
longer necessary” and that the regulatory landscape for investment advisers is now
different due to Dodd-Frank. However, this doesn’t explain why these advisers to
illiquid funds pose more money laundering risk than they did in 2002. In fact, one could
argue that now that they are registered with the SEC under Dodd-Frank, they pose less
risk of money laundering than in 2002, as they are now examined more frequently and
subject to the registration regime.

SBIA suggests that FinCEN, if it must impose AML program requirements and SAR
reporting requirements on SEC-registered investment advisers, limit those requirements
to those advisers that service retail clients or advise hedge funds, as opposed to those
advising illiquid funds, with no withdrawal or redemption rights, such as private equity
and venture funds. A carve out in the Proposed Rule should be made for SEC-registered
advisers that advise private equity and venture funds due to the lack of money laundering
risk these funds present. If FinCEN is unable to institute this carve-out, it should explain
why private equity or venture funds pose increased risk of money laundering activity,
when they did not in 2002.

2. The Proposed Rule Has a Disproportionately Burdensome and Costly Impact on
Smaller SEC-Registered Advisers to Private Funds In Contrast To The Benefit it
Provides

FinCEN’s rule proposal will have a significantly burdensome impact on SEC-registered
advisers to private equity funds, particularly advisers to smaller funds. Many of SBIA’s
member advisers and funds are SEC-registered, but are smaller funds for which the cost
of implementing the requirements of the Proposed Rule would be prohibitive, and as
explained above, provide little return for the investment, due to the low risk of money
laundering or terrorism finance.

The Proposed Rule imposes significant compliance burdens and costs on SEC-registered
advisers, including the setup costs in time and funds of establishing a full AML
compliance program, conducting ongoing independent testing, and providing ongoing
training to the advisers’ staff. Liability would be imposed on the adviser for detecting
suspicious transactions, requiring them to dedicate staff to monitor transactions to avoid

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SEC enforcement action. Additionally, advisers now would also have to comply with the Recordkeeping and Travel Rules to record certain extensions of credit and cross-border transfers. These costs and compliance burdens would be another weight on SEC-registered advisers to private equity funds, requiring time and money to be spent on compliance, rather than investing in domestic small businesses. This is particularly true for smaller funds that are closer to the $150 million registration limit, which now would have to divert funds from their management fee towards AML compliance, to guard against a risk that even FinCEN has acknowledged is not present with illiquid funds like private equity. Many smaller fund advisers close to the SEC-registration limit often have only two or three individuals working at the adviser to source deals, conduct due diligence on investments, and operate the fund and its traditional compliance requirements with SEC rules. Adding another layer of AML compliance for low risk activities such as advising a private equity fund would magnify the costs and time burden on these advisers, with little practical effect.

Smaller Private Equity Advisers “Know Their Customer”

Moreover, beyond the limited risk posed by the illiquid nature of these funds, smaller private equity funds know their investors. All their investors are accredited investors and most are qualified purchasers and institutional investors, with advisers required to verify the income and net worth of these investors, transparency that may deter potential money launderers. These advisers not only screen their LPs, they generally know most of their investors before they invest, as the investment relationship is an intimate, long-term relationship, particularly in regard to smaller funds. The nature of the GP/LP relationship in smaller private equity funds, beyond the illiquidity of the fund itself, also does not lend itself to terrorism finance or money laundering.

3. Investment Advisers Conduct Financial Transactions Between Other Financial Institutions that Are Subject to the Bank Secrecy Act

SEC-registered advisers, including advisers to private equity funds, generally do not hold custody of client assets or securities. SEC Rule 206(4)-2 (“Custody Rule”) requires that SEC-registered advisers must maintain custody of client funds or securities with a qualified 3rd party custodian. These third party custodians are primarily financial institutions that are already subject to the Bank Secrecy Act (“BSA”) requirements, including banks and broker-dealers. The fact that other BSA entities are conduits for conducting the registered advisers’ transactions, and are utilized to conduct capital calls, greatly reduces the risk of money laundering presented by SEC-registered advisers, particularly those advising private equity funds. FinCEN recognized this in their withdrawal of their similar proposed rule in 2008, “[i]nvestment advisers must conduct financial transactions for their clients through other financial institutions that are subject

\[8\] 17 CFR 275.206(4)-2
to BSA requirements, and their clients’ assets must be carried at these other financial institutions. Thus, as FinCEN continues to consider the extent to which BSA requirements should be imposed on investment advisors, their activity is not entirely outside the current BSA regulatory regime.” ⁹ The use of these conduits that are already subject to BSA reporting and AML compliance requirements greatly reduces the risk that registered advisers present in terms of money laundering and terrorism finance. This should be addressed and noted in the final rule released by FinCEN on this topic, and strengthens the case that advisers to private equity or venture funds that have a 2 year redemption period should not be subject to the requirements in the Proposed Rule.

In sum, FinCEN should avoid creating additional costs and burdens on private equity funds and venture funds investing in small business. Due to the lack of AML risk presented by the illiquidity in these funds, FinCEN should exempt these advisers from compliance with the Proposed Rule.

If you have any questions regarding this letter, please contact Chris Hayes, SBIA’s General Counsel at chayes@sbia.org or (202) 628-5055.

Sincerely,

Brett Palmer
President
Small Business Investor Alliance (SBIA)

⁹ Withdrawal of the Notice of Proposed Rulemaking; Anti-Money Laundering Programs for Investment Advisers, 73 Fed. Reg. at 65,569