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Alert

SEC Extends and Modifies Its No-Action Relief for BDs to Rely on RIAs for Performance of CIP

February 24, 2011

On Jan. 11, 2011, the Division of Trading and Markets (the "Division") of the U.S. Securities and Exchange Commission (the "SEC" or the "Commission"), in consultation with the Financial Crimes Enforcement Network ("FinCEN"), a bureau of the U.S. Department of the Treasury, issued a no-action letter in response to a request from the Securities Industry and Financial Markets Association ("SIFMA") in which it agreed that it would continue not to recommend enforcement action to the Commission under Exchange Act Rule 17a-8 if a broker-dealer relies on a registered investment adviser ("RIA") to perform some or all of its Customer Identification Program ("CIP") obligations under Section 326 of the USA PATRIOT Act of 2001 (the "PATRIOT Act") and 31 C.F.R. § 103.122 thereunder (collectively, the "CIP Rule"), subject to certain enumerated conditions. Modeled on its 2004 and other similar no-action letters, this most recent no-action letter added some significant new conditions.[1]

On Feb. 12, 2004, the Division issued a letter (the "2004 Letter") stating that it would not recommend enforcement action to the Commission if a broker-dealer relies on an investment adviser, prior to such adviser becoming subject to an Anti-Money Laundering Program Rule ("AML Program Rule") under 31 U.S.C. 5318(h), provided all the other requirements and conditions in paragraph (b)(6) of the CIP Rule are met, namely that: (1) such reliance is reasonable under the circumstances; (2) the investment adviser is regulated by a Federal functional regulator; and (3) the investment adviser enters into a contract requiring it to certify annually to the broker-dealer that it has implemented an AML program, and that it will perform (or its agent will perform) specified requirements of the broker-dealer's customer identification program. By its terms, the 2004 Letter was to be withdrawn without further notice on the earlier of: (1) the date upon which an AML Program Rule for investment advisers becomes effective or (2) Feb. 12, 2005. Because an AML Program Rule for investment advisers did not become effective, the SEC granted subsequent requests from SIFMA to extend that relief.[2]

As the SEC no-action relief was set to expire again on Jan. 11, 2011, SIFMA requested that the Division again extend the no-action relief, indicating that broker-dealers have come to rely on the no-action position that the Division took in the 2004 Letter. However, given that FinCEN withdrew the proposed AML Program Rule for investment advisers on Oct. 30, 2008, and that there was no AML Program Rule in effect for investment advisers, the Division Staff was reluctant to extend the no-action letter on the same conditions as the 2004 Letter. Although the Division ultimately decided to extend its no-action relief, enabling broker-dealers

[1] This modified no-action letter issued by the SEC on Jan. 11, 2011 does not affect the comparable no-action letter issued by the Commodity Futures Trading Commission on March 14, 2005, relating to futures commission merchants and introducing brokers that rely on registered commodity trading advisers for purposes of the CIP Rule.

[2] The SEC no-action position in the 2004 Letter was extended for an additional 18 months on Feb. 10, 2005, for an additional 18 months on July 11, 2006, for an additional two years on Jan. 10, 2008, and for an additional 12 months on Jan. 11, 2010.

to continue to rely on RIAs for performance of some or all of the CIP requirements, the Division imposed additional conditions to the 2004 Letter, as part of the relief, and modified certain of the prior conditions provided in the 2004 Letter.

As a result, the Division will not recommend enforcement action to the Commission under Exchange Act Rule 17a-8 if a broker-dealer treats an investment adviser as if it were subject to an AML Program Rule for the purposes of paragraph (b)(6) of the CIP Rule provided that the other provisions of the CIP Rule are met, and:

(1) The broker-dealer's reliance on the investment adviser is reasonable under the circumstances, as discussed in more detail below;

(2) The investment adviser is a U.S. investment adviser registered with the Commission under the Investment Advisers Act of 1940; and

(3) The investment adviser enters into a contract with the broker-dealer.

Addressing requirement (3) above, that the RIA must enter into a contract with the broker-dealer, the Division explained that, in that contract, the RIA must agree that:

(a) Not only that it has implemented its own AML Program that is consistent with the requirements of 31 U.S.C. 5318(h), but also that it will update such AML Program as necessary to implement changes in applicable laws and guidance;

(b) It (or its agent) will perform the specified requirements of the broker-dealer's CIP not necessarily in conformity with the CIP requirements, but in a manner consistent with Section 326 of the PATRIOT Act;

(c) It will promptly disclose to the broker-dealer potentially suspicious or unusual activity detected as part of the CIP being performed on the broker-dealer's behalf in order to enable the broker-dealer to file a Suspicious Activity Report ("SAR"), as appropriate based on the broker-dealer's judgment;

(d) It will certify annually to the broker-dealer that the representations in the reliance agreement remain accurate and that it is in compliance with such representations; and

(e) It will promptly provide its books and records relating to its performance of CIP to the Commission, to a self-regulatory organization ("SRO") that has jurisdiction over the broker-dealer, or to authorized law enforcement agencies, either directly or through the broker-dealer, at the request of (i) the broker-dealer; (ii) the Commission; (iii) an SRO that has jurisdiction over the broker-dealer; or (iv) an authorized law enforcement agency.

Although one of the conditions of the SEC's no-action relief relates to the obligations of the RIA to promptly disclose to the broker-dealer potentially suspicious or unusual activity detected as part of the CIP being performed on the broker-dealer's behalf in order to enable the broker-dealer to file a SAR, in this respect, the Division reminds firms that nothing in this no-action letter relieves a broker-dealer of its obligation to establish policies, procedures, and controls that are reasonably designed to detect and report suspicious activity that is attempted or conducted by, at, or through the broker-dealer.

Notably, with respect to the requirement that the reliance on the RIA must be reasonable under the circumstances, the Division indicated that broker-dealers seeking to rely on the SEC's no-action position will be expected to undertake appropriate due diligence on the RIA that is commensurate with the broker-dealer's assessment of the anti-money laundering risk presented by the RIA and its customer base. The Division also indicated its view that such due diligence must be undertaken both at the outset of the broker-dealer's relationship with the RIA and updated during the course of the relationship, as appropriate. The SIFMA letter to the Division suggested examples of appropriate due diligence which, either at the outset of or during the relationship, might include obtaining a copy of (or summary of) the RIA's CIP processes or procedures, obtaining a completed questionnaire from the investment adviser regarding its CIP program, or obtaining

attestations from the RIA relating to the adviser's performance of CIP. For example, the SIFMA letter noted SIFMA's view that an affiliate might be considered lower risk than a less well known RIA, and that such attestations could include, by way of example, that an affiliate is in compliance with the parent company's global CIP. While the SEC did not necessarily agree with the assertions in this regard by SIFMA, it is the author's view that the Division found these suggestions generally acceptable.

So that broker-dealers wishing to avail themselves of the relief being granted pursuant to the SEC's no-action letter have sufficient time to become compliant with its terms, the SEC has extended the relief granted pursuant to its previous no-action letter for 120 days, until May 11, 2011. After that date, the SEC's 2010 no-action letter will be withdrawn without further action, and the terms of the SEC's Jan. 11, 2011 no-action letter will control.

In response to comments from SIFMA, the Division recognized that some broker-dealers may cease to enter into reliance agreements pursuant to the terms set forth in the SEC's 2011 no-action letter. In those cases, a broker-dealer that had been obtaining forward-looking certifications need not obtain further certifications regarding an investment adviser's activities. For example, if the next certification due from the investment adviser would have applied to the upcoming year, from Jan. 11, 2011, through Jan. 11, 2012, then a broker-dealer ceasing the reliance relationship as of Jan. 11, 2011, would not be required to obtain such a certification from the investment adviser.

A broker-dealer that chooses not to avail itself of the relief being granted pursuant to the SEC's 2011 no-action letter may still contractually delegate the implementation and operation of its CIP to an investment adviser; however, the broker-dealer will remain solely responsible for assuring compliance with the CIP Rule, and therefore must actively monitor the operation of its CIP and assess its effectiveness.

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