March 17, 2011

SEC Extends Broker-Dealer Reliance on Customer Identification Programs of Investment Advisers

The SEC has recently issued a No-Action Letter that extends the ability for a broker-dealer to treat an investment adviser as if it were subject to an Anti-Money Laundering Program (AML Program) and rely on the investment adviser to perform some or all of its customer identification program (CIP) obligations under rule 31 CRF 103.122. However, in response to FinCEN and SEC concerns about renewing the No-Action relief beyond January 10, 2011, the SEC imposed additional conditions on broker-dealers who rely on the CIP of investment advisers. Historically, the primary conditions imposed on a broker-dealer relying on no-action relief was the belief that reliance was reasonable under the circumstances and the investment adviser relied-upon was contractually required to certify annually to the broker-dealer that it has implemented an AML Program, and that it (or its agent) would perform the specified requirements of the CIP.

New Conditions

Starting May 11, 2011, reliance upon No-Action relief will only be afforded to investment advisers registered in the United States who: (1) believe that such reliance is reasonable under the circumstances, and, (2) have entered into an reliance agreement, whose conditions have been substantially expanded.

The requirements for the reliance contract now include the requirement for the investment adviser to agree that:

- it has implemented its own AML Program consistent with the requirements of 31 U.S.C. 5318(h).
- it will update such AML Program as necessary to implement changes in applicable laws and guidance
- it (or its agent) will perform the specified requirements of the broker-dealers CIP in a manner consistent with Section 326 of the PATRIOT Act.
- it will promptly disclose to the broker-dealer potentially suspicious or unusual activity detected as part of the CIP being performed on the broker-dealers behalf in order to enable the broker-dealer to file a Suspicious Activity Report, as appropriate based on the broker-dealers judgment.

- 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,
- it will promptly provide its books and records relating to its performance of its CIP to the SEC, to an 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:
    - the broker-dealer,
    - the SEC,
    - an SRO that has jurisdiction over the broker-dealer, or
    - an authorized law enforcement agency.

In addition to the expansion of the terms of the reliance contract, the SEC also noted that with respect to making a determination as to the reasonableness of a broker-dealers reliance on an investment adviser, certain due diligence procedures were necessary. Broker-dealers seeking to rely on the no-action position will need to undertake appropriate due diligence on the investment adviser that is commensurate with the broker-dealers assessment of the anti-money laundering risk presented by the investment adviser, and the investment adviser's customer base. Such due diligence would be undertaken at the outset of the broker-dealers relationship with the investment adviser, and updated during the course of the relationship, as appropriate.

Action Items – Broker-Dealers

As the compliance date for the No-Action Letter is May 11, 2011, broker-dealers will need to take appropriate action, which at a minimum will include the following:

- The broker-dealer should determine if the registered investment advisers currently utilizing reliance contracts will execute a new contract with the expanded language.
- If the broker-dealer ceases its reliance on the No-Action Letter with respect to any particular investment adviser, effective January 11, 2011, the broker-dealer should commence performing its own CIP on new customers introduced through the respective adviser.
- If the broker-dealer intends to continue its reliance on the No-Action Letter, the broker-dealer needs to:
    - Have the expanded reliance agreement prepared and executed by the respective investment advisers on or before May 11, 2011.
    - Document the file for the respective investment adviser as to the due diligence measures which have been undertaken that is commensurate with the broker-dealers assessment of the anti-money laundering risk presented by the investment adviser and the investment adviser's customer base.
    - Amend the written supervisory procedures of the broker-dealer to address the new requirements related to the reliance contract and the due diligence related to the determination as to whether the reliance is reasonable.

Action Items – Investment Advisers

Investment advisers will also need to take appropriate action, which will at a minimum include the following:

- Confirm whether they currently have reliance agreements in place. To the extent they do, determine if they will agree to comply with the expanded conditions and terms of the new reliance agreements.
- If the investment adviser determines that it will not execute the expanded reliance agreement, it should advise the respective broker-dealer immediately so that the broker-dealer can implement its own CIP with respect to that advisers new clients.
- If the investment adviser determines that it will execute the new reliance contract, the adviser should:
    - Take immediate steps to confirm that it has implemented its own AML Program consistent with the requirements of 31 U.S.C. 5318(h).
    - Update its AML Program procedures to address (i) implement changes in applicable laws and guidance; (ii) that it (or its agent) will perform the specified requirements of the broker-dealers CIP in a manner consistent with Section 326 of the PATRIOT Act, and that it will promptly disclose to the respective broker-dealer potentially suspicious or unusual activity detected as part of the CIP being performed in order to enable the broker-dealer to file a Suspicious Activity Report, if necessary.

We hope that this information has been helpful to you. Should you have any additional questions or concerns, please feel free to contact Daniel E. LeGaye or Michael Schaps by e-mail or phone, at 281-367-2454, or consult with your legal counsel or third party consultant.