CATO INSTITUTE | Center for Monetary and Financial Alternatives

April 15, 2024

Via Federal E-Rulemaking Portal

Policy Division
Financial Crimes Enforcement Network
P.O. Box 39
Vienna, VA 22183

Re: Docket Number FINCEN-2024-00006, RIN 1506-AB58
Financial Crimes Enforcement Network: Anti-Money Laundering/Countering the Financing of Terrorism and Suspicious Activity Report Filing Requirements for Registered Investment Advisers and Exempt Reporting Advisers

To Whom It May Concern:

My name is Jennifer Schulp, and I am the director of financial regulation studies at the Cato Institute's Center for Monetary and Financial Alternatives. I appreciate the opportunity to comment on the Financial Crimes Enforcement Network's (FinCEN) proposed rule addressing "Anti-Money Laundering/Countering the Financing of Terrorism and Suspicious Activity Report Filing Requirements for Registered Investment Advisers and Exempt Reporting Advisers," which seeks to include "certain investment advisers in the definition of 'financial institution' under the Bank Secrecy Act (BSA), prescribe minimum standards for anti-money laundering/countering the financing of terrorism (AML/CFT) programs to be established by covered investment advisers, [and] require covered investment advisers to report suspicious activity to FinCEN pursuant to the BSA," among other things.[1]

The Cato Institute is a public policy research organization dedicated to the principles of individual liberty, limited government, free markets, and peace, and the Center for Monetary and Financial Alternatives focuses on identifying, studying, and promoting alternatives to centralized, bureaucratic, and discretionary financial regulatory systems. The opinions I express here are my own.

[1] Notice of Proposed Rulemaking, "Financial Crimes Enforcement Network: Anti-Money Laundering/Countering the Financing of Terrorism and Suspicious Activity Report Filing Requirements for Registered Investment Advisers and Exempt Reporting Advisers," Docket No. FINCEN-2024-0006, 89 Fed. Reg. 12108, 12108 (Feb. 15, 2024), https://www.govinfo.gov/content/pkg/FR-2024-02-15/pdf/2024-02854.pdf ("Notice").

FinCEN's characterization of this proposal as aiming to "close [a] gap" in AML/CFT obligations is inapt. Investment advisers do not provide services that are akin to those provided by covered financial institutions, and, because they do not have custody of client assets, investment advisers do not provide a "access" into the U.S. financial system.[2] Moreover, the significant costs of this proposal are not outweighed by its marginal benefits, particularly in light of a lack of evidence that an ever-expanding pool of suspicious activity reporting plays any significant role in minimizing illicit activity.[3] FinCEN should withdraw this proposed rule.

Investment Advisers Should Not Be Included in The Definition of "Financial Institution"

As FinCEN recognizes, the Bank Secrecy Act provides the bureau with the authority to designate as a "financial institution" any business "which engages in any activity which the Secretary of the Treasury determines, by regulation, to be an activity similar to, related to, or a substitute for any activity" in which a statutorily defined "financial institution" engages. The registered investment advisers (RIAs) and Exempt Reporting Advisers (ERAs) that FinCEN proposes to include in the definition of "financial institution," and thus subject to AML/CFT requirements under the BSA, do not engage in activities similar to, related to, or substituted for the activities undertaken by the statutorily listed entities.

By and large, entities defined as "financial institutions" in the statute have in common the fact that they have custody over customer's funds. Banks and broker-dealers fit this mold, but so do currency exchanges, insurance companies, pawnbrokers, and casinos. Investment advisers, by contrast, do not take custody of a customer's funds. The actual physical custody of cash or securities in an investment adviser client's account is maintained by a "qualified custodian," such as a bank or broker-dealer who are "financial institutions" subject to the BSA. The client merely authorizes the bank or broker-dealer to accept investment management instructions from the adviser.

Investment advisers, then, are not engaging in activities similar to, or substituting for, those activities performed by financial institutions. The fact that investment advice—or directions about management of funds—may be provided by any of these entities is beside the point. Investment advisers must act in conjunction with already covered financial institutions to serve their clients. As FinCEN recognized in 2008, when withdrawing previous proposals to subject investment advisers to AML/CFT requirements, "investment advisers must conduct financial transactions for their clients through other financial institutions that are subject to BSA

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[2] Notice at 12108.

[3] Indeed, as Treasury has acknowledged, the "most common form of illicit activity involving investment advisers identified in the scope of [its] assessment involves IAs defrauding their clients,"—a type of illegal activity unlikely to be significantly curtailed through the implementation of an AML/CFT regime. Department of the Treasury, "2024 Investment Adviser Risk Assessment," at 25 (Feb. 2024), https://home.treasury.gov/system/files/136/US-Sectoral-Illicit-Finance-Risk-Assessment-Investment-Advisers.pdf ("Treasury Risk Assessment").

requirements, and their clients' assets must be carried at these other financial institutions."[4] Accordingly, the activity of investment advisers "is not entirely outside the current BSA regulatory regime."[5]

While the amount of assets under management by investment advisers has increased, this basic fact—that investment advisers do not custody client assets and must work in connection with a covered "financial institution"—has remained unchanged throughout the past two decades during which similar proposals have been made and then withdrawn.

Even if some investment adviser activity was more closely related to the activities undertaken by covered financial institutions, this proposal paints investment advisers with too broad of a brush. Investment advisers—even when limited to RIAs and ERAs—serve many different roles, including advisers who directly interface with clients and those, including subadvisers and advisers to investment companies, who have little or no direct contact with the ultimate client. Investment advisers who exercise discretion to make investment decisions on behalf of their clients also may be differently situated than those who do not. FinCEN fails to explain how these varying types of advisers all engage in activity similar to, related to, or as a substitute for any activity undertaken by covered financial institutions. At a minimum, should this proposal proceed, it must be narrowed to capture only investment advisers who engage in activities that arguably more closely resemble financial institution activities.[6]

The Significant Costs of This Proposal Are Not Justified by Its Tenuous Benefits

FinCEN admits that the potential benefits of this proposal "are difficult to quantify,"[7] and assesses the costs at approximately $8 billion over a 10-year time horizon.[8] Unfortunately, FinCEN's analysis both understates the proposal's costs and overstates its benefits.

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[4] Withdrawal of Notice of Proposed Rulemaking, "Financial Crimes Enforcement Network; Withdrawal of the Notice of Proposed Rulemaking; Anti-Money Laundering Programs for Investment Advisers," RIN 1506-AA71, 73 Fed. Reg. 65568, 65569 (Nov. 8, 2008), https://www.govinfo.gov/content/pkg/FR-2008-11-04/pdf/E8-26205.pdf.

[5] *Id.*

[6] FinCEN also fails to grapple with another aspect of investment advisory services that make them unique from the activities engaged in by covered financial institutions: the fiduciary duty owed by advisers to their clients. *See* SEC, "Commission Interpretation Regarding Standard of Conduct for Investment Advisers," Investment Advisers Act Release No. 5248 (June 5, 2019), 84 Fed. Reg. 33669 (July 12, 2019), https://www.govinfo.gov/content/pkg/FR-2019-07-12/pdf/2019-12208.pdf. It is unclear what the implications are of such a duty both on the obligations of advisers to safeguard client assets and the adviser's duty of loyalty to a client who may be subject to mandatory, confidential reporting to the government under AML/CFT requirements. *See, e.g.,* Jacko Law Group, "Anti-Money Laundering As Applied To Investment Advisers" (April 1, 2015), https://www.jackolg.com/anti-money-laundering-as-applied-to-investment-advisers/ (discussing whether the fiduciary duty independently requires an investment adviser to maintain a system to prevent money laundering).

[7] Notice at 12138.

[8] *Id.*

With respect to costs, FinCEN starts from the incorrect position that because investment advisers are already subject to securities regulation, they will be able to "build upon existing policies, procedures, and internal controls, or the processes undertaken to establish [them], to comply with the proposed AML/CFT rules."[9] But there is little substantive overlap between existing regulatory obligations and those proposed here. The Investment Advisers Act of 1940 and other federal securities laws serve different purposes from the Bank Secrecy Act, and it makes little sense to assume that existing regulation will provide advisers with some significant economy in implementing and execution an AML/CFT program.[10]

While other commenters may be in a better position to critique FinCEN's cost estimates, it appears likely that the bureau has underestimated the costs to implement an AML/CFT program (particularly for unaffiliated RIAs with limited existing measures), the costs to train employees, and the ongoing costs for the filing of suspicious activity reports (SARs) filing.[11] These burdens may be particularly significant for small firms, which do not have excess capacity to handle the duties of implementation and execution of an AML/CFT program with existing staff. This is particularly problematic as FinCEN already estimates the cost burden on small advisers to be non-trivial: $41,000 annually or approximately 2.4 percent of average revenues.[12]

Moreover, although FinCEN relies on an AML/CFT program being "risk-based" as a means to manage costs to financial institutions, the reality is that many financial institutions feel pressure to implement more extensive controls to minimize potential regulatory risk. As one lawyer put it with respect to the 2015 rule proposal, "[t]he effect will be that investment advisers, like other regulated entities, may find it prudent for their AML compliance program to exceed what would otherwise be required by their actual risk profiles to avoid SEC scrutiny."[13] A risk-based program, then, should not necessarily be viewed as a cost-constraining design.

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[9] Notice at 12122.

[10] *See, e.g.,* SIFMA, Commet Letter on Docket Number FinCEN-2014-0003 (November 2, 2015) at 20-21.

[11] *See, e.g.,* Andrew E. Bigert, "FinCEN Issues Proposed Rule Requiring Investment Advisers to Establish Anti-Money Laundering Programs," Venable LLP (Sept. 15, 2015), https://www.venable.com/insights/publications/2015/09/fincen-issues-proposed-rule-requiring-investment-a (discussing costs in association with 2015 rule proposal).

[12] Notice at 12139. The shift from broker-dealers to investment advisers that Treasury recognized as a "regulatory vulnerability" is due in part to rising costs of broker-dealer compliance. Treasury Risk Assessment at 29; *see, e.g.,* Janet Levaux, "Why Brokers Want to Go Indie, in 7 Charts," *ThinkAdvisor* (Dec. 19, 2017), https://www.thinkadvisor.com/2017/12/19/why-brokers-want-to-go-indie-in-7-charts/. The impact of imposing some of those same costs on small investment advisers should be considered.

[13] Andrew E. Bigert, "FinCEN Issues Proposed Rule Requiring Investment Advisers to Establish Anti-Money Laundering Programs," Venable LLP (Sept. 15, 2015), https://www.venable.com/insights/publications/2015/09/fincen-issues-proposed-rule-requiring-investment-a; *see also* Gibson Dunn, "FinCEN Proposes Regulations That Would Requires AML Programs and Suspicious Activity Reporting for SEC Registered Investment Advisers," (Sept. 1, 2015), https://www.gibsondunn.com/fincen-proposes-regulations-that-would-require-aml-programs-and-suspicious-activity-reporting-for-sec-registered-investment-advisers/ ("Ultimately, based on the experience of most BSA financial institutions, government expectations will evolve and increase, and the specific expectations often will be revealed through the

While FinCEN understates the costs of this proposal, it also overstates its benefits. The bureau describes this proposal as strengthening law enforcement investigations of certain financial crimes, improving the understanding of priority national security threats, and protecting the U.S. financial system from abuse.[14] Even assuming that the current AML/CFT regime effectively delivered these benefits—an assumption that should not be taken for granted[15]—FinCEN overstates the degree to which such benefits will be realized through the enactment of this particular proposal.

Most importantly, an analysis of the benefits must consider the fact that many investment advisers already engage with formal AML/CFT monitoring and reporting processes both as service providers[16] to, and clients of, covered financial institutions. Thus, FinCEN should recognize any benefit here as an increase over the current level of engagement, not over a baseline of no current benefit whatsoever. This is particularly important when considering investment advisers as clients of covered financial institutions. FinCEN and Treasury articulate a concern that in the absence of treating investment advisers as covered financial institutions, "law enforcement would have to rely on information about investment advisers' clients as reported by banks, broker-dealers, and other financial institutions that do have reporting obligations but lack direct access to the underlying advisory client."[17] But this concern fails to take into account the obligations of covered financial institutions to uncover information about the beneficial owner of the funds.[18] The proposed rule then offers only a marginal benefit over the efforts of existing financial institutions, not a completely new source of information.

Moreover, the benefit here may be even less significant due to existing duties borne by many investment advisers to "know" their customer, due to rules about who may invest in private

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examination process."); Norbert Michel and Jennifer J. Schulp, "Revising the Bank Secrecy Act to Protect Privacy and Deter Criminals," Cato Institute Policy Analysis No. 932 (July 26, 2022), https://www.cato.org/policy-analysis/revising-bank-secrecy-act-protect-privacy-deter-criminals#costs-benefits-bsaaml-regime (describing defensive SAR filing) ("Michel and Schulp Policy Analysis").

[14] Notice at 12148-50.

[15] *See, e.g.,* Kathryn Judge and Anil K. Kashyap, "Anti-Money Laundering: Opportunities for Improvement," White Paper, Wharton Initiative on Financial Policy and Regulation, https://wifpr.wharton.upenn.edu/wp-content/uploads/2024/03/WIFPR-Anti-Money-Laundering-Judge-and-Kashyap.pdf; Michel and Schulp Policy Analysis.

[16] *See* Request for No-Action Relief Under Broker-Dealer Customer Identification Program Rule (31 C.F.R. § 1023.220), SEC Staff No-Action Letter (Jan. 9, 2015) available at: http://www.sec.gov/divisions/marketreg/mr-noaction/2015/sifma-010915-17a8.pdf.

[17] Treasury Risk Assessment at 20.

[18] For example, as Treasury recognizes, the Securities and Exchange Commission has promulgated regulations for broker-dealers to comply with certain BSA regulations and has pursued enforcement action against broker-dealers that failed to apply AML/CFT obligations to their investment adviser customers. Treasury Risk Assessment at 33 (footnotes omitted). FinCEN also provides no evidence that certain advisers, such as those who have little contact with individual clients, is in a better position to provide AML information to authorities than the individual client's covered financial institution that already has access client's financial activities.

funds and requirements to verify the income and net worth of such investors. Such advisers, and others, are also already subject to rules and incentives that result in advisers keeping a watchful eye out for illegal or illicit activity. The records that RIAs and ERAs are required to keep relating to their businesses, including records pertaining to investment advice and transactions in client accounts with respect to such advice,[19] are already available to law enforcement if a warrant has been obtained, and regulators have access to that information through their examination process. It is unclear how much additional benefit subjecting investment advisers to an AML/CFT regime will bring.

In sum, even if investment advisers were properly considered financial institutions under the BSA, the high costs of this proposal exceed its marginal benefits.

Further Expansion of the BSA Is Not Justified and Limits Access to Financial Services

FinCEN relies heavily on the number of SARs filed as a proxy for the effectiveness of the AML/CFT system. FinCEN estimates that under this proposal investment advisers each will file approximately 60 SARs per year,[20] a total of more than 1.2 million more SARs per year. While the total number of reports—whether from investment advisers alone or for the entire BSA reporting regime—may be impressive in magnitude, it says little about the regulatory framework's success.

In fact, it appears that FinCEN is flooded with meaningless reports.[21] The Bank Policy Institute conducted an empirical study in 2018 that found a sample of 19 financial institutions reviewed approximately 16 million alerts and filed over 633,000 SARs.[22] Those reports rarely resulted in additional review from law enforcement.[23] Even fewer likely resulted in stopping or apprehending criminals. Moreover, public reporting by FinCEN fails to properly indicate how many reports lead to secondary investigation, legal action, or conviction.[24] Overall, the

[19] *See* 17 C.F.R. § 275.204-2.
[20] Notice at 12156.
[21] *See* Norbert Michel and Nicholas Anthony, Comment Letter to FinCEN regarding Review of Bank Secrecy Act Regulations and Guidance (Feb. 7, 2022) at 2, https://www.cato.org/sites/cato.org/files/2022-02/michel-anthony-public-comment-2-7-2022.pdf.
[22] Bank Policy Institute, "Getting to Effectiveness—Report on U.S. Financial Institution Resources Devoted to BSA/AML & Sanctions Compliance," Bank Policy Institute (Oct. 29, 2018), https://bpi.com/wpcontent/uploads/2018/10/BPI-AML-Sanctions-Study-vF.pdf.
[23] *Id.*
[24] *See* Norbert Michel and Nicholas Anthony, Comment Letter to FinCEN regarding Review of Bank Secrecy Act Regulations and Guidance (Feb. 7, 2022) at 1, https://www.cato.org/sites/cato.org/files/2022-02/michel-anthony-public-comment-2-7-2022.pdf; *see also* Nicholas Anthony, "Is the Bank Secrecy Act Effective at Stopping Crime? No One Knows," *Cato At Liberty* (June 2, 2023), https://www.cato.org/blog/bank-secrecy-act-effective-stopping-crime-no-one-knows; Nicholas Anthony, "DOJ and Treasury Silent on Financial Surveillance Statistics Despite Congressional Mandate," *Cato At Liberty* (Feb. 21, 2023), https://www.cato.org/blog/doj-treasury-silent-financial-surveillance-statistics-despite-congressional-mandate.

evidence suggests that the AML regulatory framework has done little more than produce an information overload through excessive reporting.[25]

In an attempt to comply with the BSA, financial firms may be reluctant to take on customers or activities that make their regulatory compliance more difficult. In fact, in 2018, the GAO "determined that Bank Secrecy Act/anti–money laundering (BSA/AML) regulatory concerns have played a role in banks' decisions to terminate and limit customer accounts and close bank branches."[26] Though not explicit, the AML regulatory framework imposes costs on would-be financial services customers, with firms simply refusing to provide some financial services to certain customers.[27] These rules have also likely contributed to financial firms' hesitancy to work with emerging industries, such as blockchain-based technologies. This hesitancy can hinder innovation and competition in financial markets, one of several difficult-to-quantify costs associated with this regulatory regime. These costs, borne by those who seek to use financial services, should not be extended to investment advisory services.[28]

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Thank you for the opportunity to comment on this proposed rule. I am happy to answer any questions or further engage on this topic.

Sincerely,

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[25] Michel and Schulp Policy Analysis.

[26] Government Accountability Office, "Bank Secrecy Act: Derisking along the Southwest Border Highlights Need for Regulators to Enhance Retrospective Reviews," GAO-18-263 (Feb. 26, 2018), https://www.gao.gov/products/gao-18-263.

[27] For instance, long before 2022, many Russian Americans had their accounts closed by banks who feared being liable for AML violations simply due to these customers' connections to Russia. Masha Gessen, "Banking while Russian," *New York Times* (Feb. 11, 2014), https://www.nytimes.com/2014/02/12/opinion/gessen-the-checks-in-the-mail.html. Similarly, firms providing foreign remittance services have been increasingly scrutinized under the AML regime since the early 2000s; of more than 80 money transfer operators across 13 countries, almost half had their bank accounts closed. Manuel Orozco, Laura Porras, and Julia Yansura, "Bank Account Closures: Current Trends and Implications for Family Remittances," Inter-American Dialogue (Dec. 2015) at 2, https://www.thedialogue.org/wp-content/uploads/2015/12/AccountClosures_final_12.22.15.pdf.

[28] Equally important, but beyond the scope of this discussion, is the intrusion of the Bank Secrecy Act into Americans' constitutionally guaranteed civil liberties. *See* Michel and Schulp Policy Analysis.