

INVESTMENT ADVISER ASSOCIATION

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SEC Will Not Appeal Fee-Based Brokerage Rule Decision

On May 14, the SEC announced that it would not seek further review of the March 30 decision by the U.S. Court of Appeals for the D.C. Circuit striking down its fee-based brokerage rule and would instead ask the court to allow four months for a transition of the estimated one million accounts affected by the decision. “The Commission is committed to taking the opportunity provided by this decision to improve investors’ ability to make educated decisions about their investment accounts and their financial services providers,” said SEC Chairman Christopher Cox.

“It is now time for the SEC to focus its resources on clarifying the distinctions between advisers, brokers and planners, on educating investors about these distinctions, and on protecting investors by enforcing the law in these areas.”

*IAA Executive Director
David Tittsworth*

IAA Executive Director David Tittsworth applauded the SEC’s announcement. “It is now time for the SEC to focus its resources on clarifying the distinctions between advisers, brokers and planners, on educating investors about these distinctions, and on protecting investors by enforcing the law in these areas.”

The Commission also announced that it will consider whether further rulemakings and interpretations are necessary in light of the court’s decision. “We will continue to work with the SEC on any additional rules it issues relating to these important issues,” Tittsworth said.

SEC Chairman Cox also noted that he has approved “emergency funding” to accelerate the RAND Corporation’s study of the marketing, sale,

and delivery of financial products and services so it may be delivered to the Commission not later than December 2007. According to the SEC’s press release, the results of the study are expected to provide “an important empirical foundation for considering improvements in regulatory and legislative rules [governing the brokerage and adviser industries] that date back to the 1930s.”

In seeking a four-month stay of the decision to allow investors and brokers time to make informed decisions about transitioning out of fee-based brokerage accounts – either to traditional, commission-based accounts or to fee-based advisory accounts – the SEC pledged to work with individual firms during this period.

According to research firm Cerulli Associates, the 1 million fee-based brokerage accounts affected by the court decision held about \$277.4 billion in assets at the end of 2006.

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IAA Web Site Enhancements

New and Improved Legal, Regulatory and Compliance Section

The IAA legal staff is pleased to announce a number of significant improvements to the Members Only area of the IAA web site. “We have been working to update and organize our library of materials to provide a wide range of valuable resources to all IAA members,” said IAA Assistant General Counsel Valerie Baruch. “As we continue to update and enhance our web site, we welcome any additional suggestions from our members.”

Legal, Regulatory, and Compliance Materials. The Legal, Regulatory and Compliance section of the Members Only area has been reorganized by consolidating resources from previously separate resources (*IAA Investment Adviser and IAA On-line Compliance Guide*) and by updating topics with a variety of materials. The new section provides members with information on the following twenty-eight topics:

- Advertising, Marketing, and Other Communications
- Advisory and Sub-Advisory Contracts/Account Opening Procedures
- Anti-Money Laundering
- Books and Recordkeeping Requirements
- Brokerage and Trading Practices (Principal and Agency Cross Transactions, Best Execution, Allocation and Aggregation of Orders)
- Business Continuity/Contingency Plans
- Class Actions
- Compliance Programs and Controls
- Custody and Safeguarding of Client Assets
- Electronic Media
- E-mail Communication and Retention
- ERISA Requirements and Other Pension Plan Issues
- Form ADV, Registration and Disclosure
- Hedge Funds/Private Offered Investment Companies
- Insider Trading/Material Non-Public Information
- International Issues
- Market Regulation
- Performance Fees
- Personal Trading/Codes of Ethics
- Portfolio Management Processes
- Privacy/Safeguarding Customer Information/Regulation S-P
- Proxy Voting
- Referral Arrangements (Solicitation)
- Reporting Requirements Under the 1934 Act and the Treasury Department
- Soft Dollars
- State Filing/Blue Sky Issues
- Supervisory Duties
- Wrap Fee/Separately Managed Account Arrangements

Each of the above topics is organized into the following four sub-sections: (a) IAA Guidance; (2) IAA Comment Letters and Statements; (3) Outlines, Articles, and Memoranda; and (4) Selected Rules and Other Regulatory Guidance.

In addition to the Legal, Regulatory and Compliance Materials, the Members Only area also features a separate section on SEC and DOL examinations, including numerous document request letters. The Members Only area also contains archived *IAA Newsletters*, Legal & Regulatory Updates, and the IAA Service Provider Directory that lists various companies that offer products and services for investment advisers.

If you have any questions about the content of the Legal, Regulatory and Compliance section, please contact Valerie Baruch (valerie.baruch@investmentadviser.org.)

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Legal & Regulatory Update

US Court of Appeals Finds against SEC Interpretation of Investment Company Filing Requirements

On May 15, 2007, the U.S. Court of Appeals for the Seventh Circuit in Chicago found that a company did not have to register with the SEC as an investment company despite the fact that at one time more than 40 percent of its total assets were in “investment securities” of other companies.

The subject company had sold substantial assets used to produce munitions in the United States when the Department of Defense closed a facility that the company had used to make artillery shells. The company had a “pile of cash” that it invested awaiting future deployment of the capital at a later date. Further, the company now produces its line of pots and pans overseas with less capital invested. The company continued to claim to be an “operating company” and continued to file disclosure documents under the Securities Exchange Act of 1934. The SEC required the company to file as an Investment Company under the Investment Company Act despite significant income from continuing operations and an additional line of business in the United States that involved production of adult diapers. The company’s auditors quit because they had prepared financial statements on the basis of an “operating company” and now the SEC was requesting financial statements on the basis of an investment company. The SEC staff had told the company they expected restatements of 2002 and 2003 year end numbers by any new auditor along with the most recent financial statements, all to be presented as an investment company. The company had tried to follow the SEC’s guidance by registering as an investment company on Form N-2 and immediately filed a Form N-8F seeking deregistration because by this time the company had made sufficient adjustments to its balance sheets to hold less than 40 percent of its assets in investment securities. The SEC never approved the deregistration request.

The SEC commenced an injunctive action to force the company to comply with the Investment Company Act requirements. The court of appeals found that the company is an operating company and doesn’t need to register as an investment company. The SEC will determine what course of action to take as to this most recent adverse legal decision. *See Securities and Exchange Commission v. National Presto Industries, Inc., 7th Cir., No. 05-4612 (May 15, 2007) available at <http://www.ca7.uscourts.gov/tmp/381FFFWQ.pdf>.*

SEC Provides Broker-Dealer No-Action Relief from Rule 10b-10 Requirements for Wrap-Fee Accounts

On April 30, 2007, the SEC’s Division of Market Regulation issued a no-action letter granting relief from the trade-by-trade confirmation delivery requirements of Rule 10b-10(a) for securities transactions effected by both discretionary broker dealers and fiduciary advisers to wrap fee program clients. The relief sought allows for those broker dealers who comply with certain requirements to deliver to clients periodic statements (*e.g.* quarterly) that contain the same information required by rule 10b-10, in lieu of the trade-by-trade confirmations otherwise mandated by the rule.

Any broker-dealer or adviser to wrap fee program clients intending to take advantage of this relief must comply with the stated conditions, including: the firm must provide all Program Clients, at or prior to account opening, and at least annually thereafter, with an offer to provide the confirmations; the firm must provide a brochure describing the products, services, and fees of the wrap fee programs; program clients must receive the opportunity to access all information that is otherwise required by rule 10b-10 on the broker-dealer’s website no later than the next business day following execution of the trade (T+1); and the form of consent required

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for this exemption must be prominent, clear and easily understandable. See *SEC No-Action Letter to Jack P. Drogin, re Wachovia Securities LLC*; (Apr. 30, 2007), available at <http://sec.gov/divisions/marketreg/mr-noaction/2007/wachovia043007-10b-10.pdf>.

Broker-Dealer Sanctioned Over Failure to Seek Best Execution

On May 9, 2007 the SEC announced the institution of settled administrative proceedings and the imposition of remedial sanctions against a large registered broker-dealer that failed to seek best execution. The respondent allegedly “recklessly programmed” its order execution system to receive amounts that should have gone to customers, thereby failing to seek best execution and defrauding customers in certain retail orders for over-the-counter (OTC) securities processed by its automated market-making system. In particular, the respondent allegedly embedded undisclosed mark-ups and mark-downs on certain retail orders without the customer’s prior consent, as well as developing and implementing a trading mechanism that slowed the execution of orders so that the dealer could try to obtain price improvement for multiple orders.

The SEC’s order finds that the respondent failed to provide best execution for approximately 1.25 million executions (3.7% of its OTC executions) in transactions valued at approximately \$8 billion. The firm recognized revenue of approximately \$5.95 million through its improper use of undisclosed mark-ups and mark-downs. As a result, the order finds that the respondent willfully violated the anti-fraud provisions of Section 15(c)(1)(A) of the Securities Exchange Act.

Without admitting or denying the findings, the respondent consented to the entry of an order instituting administrative proceedings, censuring the respondent, and imposing civil penalties. The order requires the respondent to desist from committing or causing any violations of Section 15(c)(1)(A) of the Exchange Act; to pay disgorgement of \$5,949,222 and prejudgment interest thereon of \$507,978. The order also imposes a civil money penalty of \$1.5 million and requires the respondent to comply with certain undertakings, including (a) retaining an independent compliance consultant to conduct a comprehensive review of, and to provide a report concerning, its automated retail order handling practices and (b) retaining an independent distribution consultant to develop and implement a distribution plan for the distribution of the disgorgement ordered. See *In the Matter of Morgan Stanley & Co Inc*, SEC Rel. 34-55726, File No. 3-12631; and Rel. 2007-91, (May 9, 2007), available at <http://sec.gov/litigation/admin/2007/34-55726.pdf> and <http://sec.gov/litigation/admin/2007/34-55726.pdf>, respectively.

SEC Sues Holding Company for Providing Funding For Hedge Funds Participating in Market Timing Violations

On May 7, 2007, the SEC brought and settled administrative proceedings against a corporation that aided and abetted market timing frauds by four hedge funds by providing financing. The hedge funds used various deceptive techniques designed to avoid detection by mutual funds. The respondent learned of the deceptive practices but nonetheless provided financing and took administrative steps that substantially assisted the hedge funds. The SEC claims jurisdiction over the respondent because it controlled and at all relevant times owned a US registered broker/dealer. The company is also affiliated with a Swiss holding company.

The SEC’s order included: a directive to comply with offered undertakings to cooperate with SEC staff; an order to disgorge \$11 million, pay pre-judgment interest of \$1,809,354.42, pay civil money penalty of \$4 million (for a total payment of \$16,809,354.42); an order to cease from future fraud violations; and the respondent is censured. A Fair Fund will be established to distribute the funds to the affected mutual funds. See *In Re Zurich Capital Markets Inc.*, Adm. File No. 3-12628 (May 78, 2007), available at <http://www.sec.gov/litigation/admin/2007/34-55711.pdf>.

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Pending Regulatory Proposals

The IAA intends to or is considering whether to file a comment letter regarding each of the regulatory proposals reflected in the following chart. If you have any questions or feedback about a regulatory proposal or potential IAA comments regarding a proposal, please contact the member of the IAA legal staff listed below. To obtain a copy of the regulatory proposals set forth below, see the Regulatory Proposals section of our web site. This chart reflects only certain formally pending regulatory proposals. For a complete list of comment letters filed by the IAA, see the Comments & Statements section of our Web site.

Regulatory Proposal	IAA Attorney Contact	Deadline
<p>Interagency Proposal for Model Privacy Form Congress mandated that the appropriate federal agencies work together to provide standardized model Privacy Act disclosures for customers (Financial Services Regulatory Relief Act). Eight federal agencies that regulate financial institutions (five banking agencies, CFTC, FTC, and SEC) issued an “Interagency Proposal for Model Privacy Form Under the Gramm-Leach-Bliley Act; Proposed Rule,” 72 <i>Federal Register</i> 14940, (Mar. 29, 2007).</p>	Paul Glenn	May 29, 2007
<p>CSA Adviser Registration Proposal The Canadian Securities Administrators have issued a proposal for a uniform set of registration requirements for investment advisers, including for non-resident advisers that have Canadian clients.</p>	Valerie Baruch or Paul Glenn	June 20, 2007
<p>IOSCO Paper on Hedge Fund Valuation The International Organization of Securities Commissions (IOSCO) released a consultation report for public comment entitled, “<i>Principles for the Valuation of Hedge Fund Portfolios</i>.” The stated goal of the principles is to promote the consistent application of a set of valuation policies and procedures in the valuation of hedge fund portfolios and independence in, and transparency of, the valuation process. IOSCO hopes to develop a single, global set of principles relating to the valuation of the financial instruments employed or held by hedge funds when implementing their strategies.</p>	Monique Botkin	June 21, 2007
<p>DOL Seeks Comments on 401k Fee Disclosure The Department of Labor is reviewing the rules under ERISA applicable to the disclosure of plan administrative and investment-related fee and expense information to participants and beneficiaries in 401(k) plans. The stated purpose of this review is to determine to what extent rules should be adopted or modified, or other actions should be taken, to ensure that participants and beneficiaries have the information they need to make informed decisions about the management of their individual accounts and the investment of their retirement savings. The stated purpose of the notice is to solicit views, suggestions and comments from plan participants, plan sponsors, plan service providers and members of the financial community, as well as the general public.</p>	Karen Barr	July 24, 2007

ERISA Advisory Council Recommends Additional Cross-Trading Relief

Last month, the Working Group on Plan Asset Rules, Exemptions and Cross Trading of the ERISA Advisory Council on Employee Welfare and Pension Benefit Plans (EAC Working Group) issued a written report advising the Secretary of Labor to further enable investment advisers to ERISA plans to engage in cross trading. The ERISA Advisory Council consists of 15 members appointed to staggered three-year terms by the Secretary of Labor to provide advice on policies and regulations affecting employee benefit plans governed by ERISA. Its members represent the general public, employers, employee organizations and the financial industry. Last fall, the EAC Working Group reviewed the use of cross trading by ERISA plans, particularly in light of the passage of the Pension Protection Act, which enables investment advisers to ERISA plans to engage in cross trading if plan assets exceed \$100 million.

Overall, the recommendations included in the written report are a positive step towards additional cross-trade relief for ERISA plans. It appears that the EAC Working Group carefully considered the testimony of the joint panel presented by the IAA and the Investment Company Institute in September 2006. The panel, chaired by Henry Hopkins of member firm T. Rowe Price Associates, advocated for additional cross-trade relief for ERISA plans, and, among other things, sought an exemption for pooled funds, and a reduction or elimination of the \$100 million threshold set forth in the Pension Protection Act.

The EAC Working Group recommended that:

1. DOL provide exemptive relief to extend cross trading to those plans meeting the threshold level of \$50 million;
2. DOL provide guidance for circumstances in which plan assets fluctuate below the \$100 million threshold (note: this recommendation was addressed in the interim final rules issued by the Department of Labor);
3. Exemptive relief be extended to pooled funds with at least one investor with assets of at least \$100 million (or lower amount as is adopted);
4. Exemptive relief be extended to allow cross trades between plans maintained by employers in the same Controlled Group, provided that ERISA plans within the same Controlled Group have, in the aggregate, assets of at least \$100 million (or lower amount as is adopted); and
5. DOL grant a prohibited transaction exemption for cross trading by In-House Asset Managers.

The IAA continues to advocate for cross-trade relief from the Department of Labor and is planning to encourage the Secretary of Labor to act on the EAC Working Group recommendations. If you have any questions regarding the EAC Working Group recommendations, please contact Valerie Baruch at Valerie.baruch@investmentadviser.org. For a copy of the Working Group report, go to http://www.dol.gov/ebsa/publications/AC_1106c_report.html See Comments & Statements on the IAA Web site for a copy of the IAA's written submission to the EAC Working Group.

Compliance Corner

Anti-Money Laundering – Where Do Investment Advisers Fit In?

By Beth D. Kieseewetter**

In the aftermath of September 11, 2001, President Bush issued Executive Order 13224 prohibiting transactions with those involved in terrorist financing, which broadened existing rules and regulations enforced by the U.S. Treasury Department's Office of Foreign Assets Control ("OFAC") that prohibit all United States entities and individuals from transacting or dealing in the property or interests of any persons deemed to be involved in terrorist financing, money laundering and other illicit activities. The President also signed into law the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (the "USA PATRIOT Act" or the "Act"). Among other things, the Act made a number of amendments to the anti-money laundering ("AML") provisions of the Bank Secrecy Act (the "BSA"). As one would expect, the amendments were designed to promote the prevention, detection, and prosecution of money laundering and the financing of terrorism.

The USA PATRIOT Act also gave the Department of the Treasury, the SEC and other agencies, broad authority to issue regulations under the Act. In May 2003, the Treasury Department used this authority and issued a proposed regulation that, if adopted, will require certain investment advisers to establish AML programs. However, in the intervening four years, little movement towards adopting the proposed rule has occurred. In the absence of a final AML program rule, registered investment advisers often wonder where they fit into the U.S. regulatory framework designed to combat money laundering, terrorist financing and other financial crimes. This article discusses existing AML requirements with which investment advisers must currently comply and suggests a number of additional steps that investment advisers should consider taking in order to detect and deter money laundering or other illicit activities and also protect themselves from potential reputational and other serious risks.

CURRENT AML REQUIREMENTS – WHAT INVESTMENT ADVISERS MUST DO NOW

It is a common misperception within the industry that because investment advisers are not currently subject to regulations implementing the AML provisions of the USA PATRIOT Act, they are exempt from compliance with federal regulations that require the creation or maintenance of procedures to detect and deter money laundering or terrorist financing. To the contrary, investment advisers have been directly subject to certain federal AML requirements for quite some time, such as the economic and trade sanctions programs enforced by OFAC or the currency reporting requirements of the Internal Revenue Code ("IRC") and the BSA, and may also be required by the financial institutions with whom they transact to provide certifications regarding compliance with USA PATRIOT Act provisions as a pre-requisite to establishing an account or executing a transaction. As a result, investment advisers should not only consider implementing policies and procedures consistent with currently applicable federal requirements, but determine the extent to which it may be necessary to develop policies and procedures addressing the proposed rule that would require certain investment advisers to develop AML programs, which are substantially similar to those in effect for the financial institutions with whom they transact business. Although the state of the regulatory environment in which hedge funds currently operate remains in flux, we believe that the question regarding the adoption of the proposed rule for investment advisers is not whether it will be adopted, but rather when, given continued Congressional focus on preventing the use of such entities to facilitate money laundering and terrorist financing activities.

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OFAC Prohibited Transactions

Overview of OFAC Requirements

OFAC, which is part of the Treasury Department, administers and enforces economic and trade sanctions programs pursuant to Presidential and Congressional mandates that further U.S. foreign policy and national security goals against targeted foreign countries, terrorists, international narcotics traffickers and those engaged in activities related to the proliferation of weapons of mass destruction. All U.S. persons, including investment advisers, organized, operated or sponsored by a U.S. person, must comply with the requirements of OFAC that generally (i) prohibit U.S. persons from entering into various prohibited transactions with particular jurisdictions or specially designated nationals (“Prohibited Persons”), and (ii) require the blocking of accounts and property of such Prohibited Persons. Criminal violations of the statutes administered and enforced by OFAC may result in significant fines, asset forfeiture, and, in extreme cases, imprisonment.

For investment advisers that manage client assets, including the portfolios of registered or unregistered investment companies, OFAC compliance involves two separate categories of reviews: (i) the “client onboarding” process; and (ii) selection of new investments. Thus, prior to entering into a new advisory relationship with a client or making a decision to invest in a new security, and on a periodic basis thereafter, investment advisers must screen the new client’s identification information as well as identification information for proposed investment in the securities of new companies (as well as the beneficial owners of such companies) against the Specially Designated Nationals and Blocked Persons List and List of Sanctioned Countries (“OFAC Lists”) in order to prevent an OFAC violation. The OFAC Lists are available at <http://www.ustreas.gov/offices/enforcement/lists>. Entering into new advisory relationships or making investments in new companies that would otherwise be prohibited under OFAC regulations may be permitted if authorized by OFAC through a general license or specific license. Before relying on an OFAC license, however, an investment adviser should carefully verify that the advisory relationship or potential investment meets the relevant criteria of the license.

If the investment adviser’s screening process results in an OFAC match, it should consider performing additional due diligence to determine whether the OFAC match might be a false positive. If this additional due diligence reveals a true OFAC match, the investment adviser must (i) reject the transaction and/or block the investor’s assets, and (ii) file a Report of Blocked Transactions and/or a Report of Rejected Transactions with OFAC within 10 days of the requested transaction. A comprehensive report of all blocked assets must be filed with OFAC by September 30 of each year.

Suggested Practices – Developing an OFAC Compliance Program

Although not specified by regulation, OFAC recommends that entities within the securities industry establish an OFAC compliance program. Such a compliance program should include written policies and procedures, as well as internal controls that are reasonably designed to identify suspect accounts or transactions and report such information to OFAC. It is important to be mindful when considering whether to establish and implement an OFAC compliance program, that OFAC considers both the processing of transactions or continuing investment of a Prohibited Person, along with the adequacy of the entity’s overall OFAC compliance program, when determining the severity of penalty actions in the event of an OFAC violation.

The cornerstone for developing an effective OFAC compliance program for an investment adviser is an assessment of the risks presented by the investment adviser’s customer base, nature of its business activities or services, and the geographical locations in which the investment adviser operates. The OFAC compliance program should then be developed taking into account the investment adviser’s risk-weighted profile and should be supervised by a designated OFAC compliance officer. An effective OFAC compliance program must address how the investment adviser will identify and review potential investors and investments for possible OFAC

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violations as described above. The screening process for advisory clients and investments should be adequately documented in order to provide for consistent reviews, including the investment adviser's procedures for determining whether an OFAC hit is a valid or false match.

OFAC has indicated that where an entity uses a third party to perform OFAC checks on its behalf, the entity retains ultimate responsibility for the performance of those functions. Therefore, the investment adviser should establish policies and procedures that also provide for oversight of the service provider's performance. In addition, the OFAC compliance program should include policies and procedures for handling assets, property or transactions that are blocked or rejected items consistent with the applicable economic or trade sanction program's requirements, as well as procedures and processes for making the necessary reports to OFAC. Additional components of the OFAC program include employee training and performance of independent testing of the implementation of the program on a periodic basis. OFAC requires that information and documentation regarding such items and any related reports be maintained.

Currency and Monetary Instrument Reporting

In addition to the regulations enforced by OFAC, various provisions of the BSA and the IRC have for some time required the reporting of certain transfers or transactions in currency or monetary instruments by all U.S. persons, including investment advisers. In particular, pursuant to the requirements of Section 6050I of the IRC, investment advisers are required to file Form 8300 with the Internal Revenue Service to report the receipt of more than \$10,000 in cash received in one transaction or two or more related transactions. Further, the BSA requires all persons, including investment advisers, to report to the Commissioner of Customs the transportation of currency and monetary instruments of more than \$10,000 into or outside of the U.S., or such smaller amounts structured to avoid the reporting threshold, on Form CMIR. Moreover, the BSA also requires hedge funds that have a financial interest in a bank, securities or other financial account in a foreign country to report such interest to the Financial Crimes Enforcement Network ("FinCEN") on Treasury Form TD F 90-22.1 (commonly known as the FBAR form). Recommended best practice within the industry, similar to that discussed above in relation to OFAC requirements, is to develop written policies and procedures that describe the extent to which such requirements apply to the investment adviser and provide an internal controls framework to facilitate compliance with applicable reporting requirements.

Federal Statutes that Criminalize Money Laundering

Above and beyond the OFAC requirements and currency reporting requirements discussed above, investment advisers and their employees are currently subject to federal statutes that broadly criminalize money laundering activities. Sections 1956 and 1957 of title 18 of the United States Code make it a crime for any person to engage knowingly in a financial transaction that involves the proceeds of a significant number of specified crimes or illicit activities. These sections impose severe criminal penalties, up to 20 years and 10 years confinement respectively, and fines of up to twice the amount of funds involved in the illicit transaction or \$500,000, whichever is greater. Moreover, any assets or property involved in such illegal activities are generally subject to civil or criminal forfeiture.

Although these statutes are quite complex with multiple elements, their scope is very broad. In general, they may be interpreted to reach any transaction, transfer, or attempt to transact or transfer, either domestically or internationally of any funds or monetary instruments that are the proceeds of long list of crimes or "specified unlawful activity." Although each of the statutes require knowledge, such as that the defendant must have intended to promote certain felonies or have had a purpose to conceal or disguise the nature, location, source, ownership or control of the funds, defendants have been convicted for being "willfully blind". Therefore, if the investment adviser or one of its employees is involved in (interpreted broadly) the transfer of funds that they know or suspect might be derived from criminal proceeds (or they are just consciously avoiding such

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knowledge), they are at risk of having committed the crime of money laundering. *U.S. v. Susana P. Longo*, an unreported decision from the Eleventh Circuit in June 2006, describes the severe ramifications for investment advisers that become involved in violations of the federal statutes that criminalize money laundering.

PROPOSED AML REQUIREMENTS – WHAT INVESTMENT ADVISERS SHOULD CONSIDER NOW

The proposed rule issued by the Treasury Department, which is an amendment to the BSA (§103.150 Anti-Money Laundering Programs for Investment Advisers), would require two categories of investment advisers to establish an AML program. The first category includes U.S. investment advisers registered with the SEC that manage assets, while the second category includes investment advisers that manage assets but are exempt from SEC registration because they have 15 or fewer clients. These investment advisers would be required to have in place an AML program that includes, at a minimum, the following four elements: (i) the development of internal policies, procedures, and controls; (ii) the designation of an AML compliance officer; (iii) an ongoing employee training program; and (iv) an independent testing function to review the adequacy and effectiveness of the AML program.

As noted above, the proposed rule has not yet been adopted, but recent experience suggests that a rule with these four elements will be formalized. Accordingly, because such investment advisers will only have 90 days to comply with the new rule, we suggest that investment advisers consider the extent to which they should establish and implement policies and procedures to comply with the proposed rule based upon, among other factors, the following: (i) the degree to which the investment adviser is controlled by a financial institution that is currently subject to AML program requirements applicable not only to the financial institution but also to its subsidiaries; (ii) the extent to which financial institutions with which the investment adviser transacts business require letters of representation that the investment adviser has in place an AML program consistent with the requirements of the USA PATRIOT Act and implementing regulations as well as the SEC's no-action letter to the Securities Industry Association (now SIFMA); and (iii) the policies and procedures required by the proposed rule simply make good business sense as a risk-mitigation tool and represent the best practices within the industry.

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Mutual Fund Directors Forum Issues Best Practices on Rule 12b-1

The Mutual Fund Directors Forum released a report on best practices and practical guidance for directors under SEC's rule 12b-1. The report addresses the departure of the use of rule 12b-1 from its original contemplated purpose of allowing mutual funds assistance in marketing for limited periods. Now, mutual funds appear to be using 12b-1 fees to offer purchasers an alternative way to pay for services such as the sales by introducing brokers or intermediaries and to compensate brokers for shareholder accounting and other services provided to fund shareholders. The report encourages reevaluation and reform. The "best practices" guidance is designed for the benefit of fund directors responsible to oversee Rule 12b-1 plans. Boards approving the use of 12b-1 fees should identify and examine the conflicts of interest between the best interests of investors, the interests of funds to grow or sustain size, the desire for profitability, and the directors' fiduciary responsibilities. *See Best Practices and Practical Guidance for Directors Under Rule 12b-1* (May 2007), available at <http://www.mfdf.com/UserFiles/File/12b-1Report.pdf?PHPSESSID=2fd576a9f2109ba45c678bf47c51b07e>.

The IAA places a complete copy of each month's Legal and Regulatory column on the Members Only section of the IAA website. Interested readers should consult that site for the complete version of this month's Legal and Regulatory column.



Inside The Beltway

IAA Urges SEC to Reaffirm Pro-Investor Aspects of Fee-Based Brokerage Rule

IAA, together with other groups including the North American Securities Administrators Association, the Consumer Federation of American and the Financial Planning Association, wrote SEC Chairman Cox on April 24 urging the SEC to re-institute certain pro-investor aspects of the fee-based brokerage rule that were not affected by the court ruling striking it down. The letter urges the SEC to use its authority to clarify that discretionary management, financial planning services, and non-discretionary advice bearing the core characteristics of investment advisory services may not be deemed “solely incidental” to brokerage services. In the wake of the court decision, brokers providing advisory services are now exempt from the Advisers Act only if they do not charge fees and the advisory services they provide are solely incidental to their brokerage services. The full text of the letter is available on the IAA web site under “Comments & Statements.”

SEC Commissioners to Testify on Capitol Hill

The House Financial Services Committee, chaired by Rep. Barney Frank (D-MA), is planning a hearing later this month at which all SEC Commissioners are expected to testify. Frank is concerned about the deregulatory agenda advocated by certain industry groups, primarily focused on the Sarbanes-Oxley law, and wants to ensure that the SEC adheres to its pro-investor mission.

Hedge Fund Adviser Registration Act Introduced in Senate

Sen. Charles Grassley (R-Iowa) introduced legislation on May 15 that would authorize the SEC to require registration by hedge fund advisers. The SEC adopted a rule in 2004 requiring hedge fund adviser registration, but it was struck down by a 2006 court decision. Grassley’s “Hedge Fund Registration Act” would require all hedge fund advisers to register as investment advisers unless they manage less than \$50 million for fewer than 15 investors and do not hold themselves out to the public as investment advisers. Although passage of the legislation appears unlikely, its introduction evidences policymakers’ increasing concern about the adequacy of hedge fund regulation.

House Hearing on Pension Consultant Conflicts of Interest

The House Education and Labor Committee, chaired by Rep. George Miller (D-CA) will hold a hearing this month focusing on whether pension consultants’ conflicts of interest are hurting 401(k) plan participants. The hearing will examine consultants’ ties to the money managers they recommend. Miller held a hearing on March 6 on 401(k) fees and is widely expected to push legislation to provide new protections for plan participants. He is now considering whether to include reforms aimed at pension consultants.

SEC Hosts Regional CCO Outreach Seminars

This spring, SEC examination staff located in the regional offices have held CCO Outreach Seminars in a number of cities throughout the country. These seminars, which are intended to provide CCOs of small to mid-sized firms with “nuts and bolts” information about the examination process, are three to four hours long and designed to enable attendees to ask questions and interact with the staff.

The following topics have been addressed at the regional seminars: (1) the examination and risk assessment process; (2) books and records and disclosures and filings; (3) brokerage arrangements, best execution, trade allocation and soft dollars; (4) portfolio management; and (4) marketing, performance, advertising and distribution. The national CCO seminar will be held at SEC headquarters in Washington, D.C. on November 14, 2007. The seminars are free of charge, but advanced registration is required. For registration information, including a list of remaining regional seminars that will be held in June, see <http://sec.gov/info/cco/ccorscal2007.htm>. For a copy of materials distributed at the regional seminars, see the Members Only section of the IAA web site in the SEC/DOL Exams section.

IAA 2007 Webcast

The IAA is pleased to announce the following webcast for interested IAA members:

Gifts and Entertainment: Pitfalls and Best Practices **June 11, 1-2 pm ET**

Presenter: Elizabeth M. Knoblock, Partner, Mayer, Brown, Rowe & Maw LLP

Moderator: Valerie M. Baruch, Assistant General Counsel, IAA

This hour-long session features a discussion of the latest developments in coping with issues for investment advisers concerning gifts and entertainment. Learn about common pitfalls, as well as best practices, with regard to code of ethics coverage, implementing policies and procedures such as gift and entertainment logs, known or suspected violations, and much more.

Elizabeth M. Knoblock is a Partner with Mayer Brown Rowe & Maw's Washington, DC office and a member of its Corporate and Securities Practice Group. She focuses her practice on the federal, state and international laws governing the investment management of mutual funds, hedge funds and private accounts, including institutional, retail and wrap fee clientele.

REGISTRATION: The webcast is \$75 for member firms and \$95 for non-members. There are two steps to registration:

1. REGISTER FOR WEBCAST: Log on to <http://iaa.webex.com> to register on-line for the webcast.
2. ARRANGE PAYMENT: Please request a payment form from Lisa Gillette, IAA Director of Meetings and Events at lisa.gillette@investmentadviser.org or (307) 733-3332 or the IAA office at (202) 293-4222. Please type or print responses, and return to the IAA with payment. Once payment is received, you will receive an email confirmation with call-in and log-on information and pass codes.

For more information about the webcast, please contact Monique Botkin, IAA Counsel, at monique.botkin@investmentadviser.org or (202) 293-4222.

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In connection with the web site updates, IAA members will soon be accessing the password-protected Members Only area through a personalized login. *Your email address will be your new log-in name and will be required by the IAA system for entry.* You will then be able to assign your own password for entry. In anticipation of this change, please update your email information with the IAA today. Provide accurate and current email addresses for you and all authorized users at your firm. Please contact the IAA office for member support at iaa@investmentadviser.org or (202)293-4222. Address your inquiries, questions or comments directly to Garrett Honea, IAA Executive Assistant, by telephone or email (garrett.honea@investmentadviser.org).

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