WILMER, CUTLER & PICKERING

EU Financial Services Group Briefing

FEBRUARY 2003

APPLICATION OF THE ANTI-MONEY LAUNDERING REQUIREMENTS OF THE PATRIOT ACT TO NON-US FUNDS

The Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001**,** more commonly known as the USA PATRIOT Act ("Patriot Act"), imposes a variety of new anti-money laundering ("AML") requirements on various types of US and, in some cases, *foreign* (*i.e.*, non-US) financial institutions. Among the other institutions included in the Act's reach are "investment companies," a term that is not defined in either the Patriot Act or the pre-existing AML statutes on which the Patriot Act builds.

Initially, the United States Treasury Department ("Treasury"), which is given authority to implement the requirements of the Patriot Act, applied the Act's requirements exclusively to open-ended investment companies required to register under the US Investment Company Act of 1940 ("1940 Act"), so-called "mutual funds." In September 2002, however, that changed with the publication of a rule proposal to bring hedge funds and other privately sold funds within the ambit of the Patriot Act's requirements.

This is relevant to European operators, managers and promoters of both on and offshore funds, as well as to their administrators, because their funds may become subject to the Patriot Act as is now explained.

Proposed Anti-Money Laundering Rule for Non-US Funds

That rule proposal (which has not yet been finalised) would apply certain AML programme requirements to "unregistered investment companies."

Funds Covered by the Proposed Rule

For these purposes "unregistered investment company" is defined as any fund that:

(1) (a) would be an investment company under the 1940 Act, but for the exclusions provided for in sections 3(c)(1) [no more than 100 investors] and 3(c)(7) [qualified purchasers] of that Act; (b) is a commodity pool; or (c) invests primarily in real estate and/or interests therein;

(2) permits an owner [shareholder] to redeem his or her ownership interest [shares] within two years of the purchase of that interest;

(3) has total assets of $1 million or more; and

(4) is organised under the laws of the United States; is organised, operated or sponsored by a US

person; *or sells ownership interests to US persons* [our emphasis].

This definition is designed to cover a number of fund entities not registered under the 1940 Act, including hedge and other offshore funds, private equity funds, venture capital funds, commodity pools, and real estate investment trusts. In addition, any European UCITS fund or other authorised domestic fund would be caught by the Act if meeting the four criteria. (For ease of reference, all these fund types are referred to below as "private funds.")

The last of the four criteria has raised some concerns, as its jurisdictional reach is exceedingly broad; under the definition, private funds with only a tenuous link to the United States would be covered by the rule. For example, the fourth criterion would appear to capture non-US funds that have a US sponsor or a single US investor (assuming that the other criteria are met) or which, on a strict interpretation and subject to further Treasury clarification, are merely promoted in the US irrespective of whether any US person has invested. In addition, there are no exceptions for non-US private funds that may have US investors but do not market within the United States, or private funds that have US investors only because an existing foreign shareholder has moved to the United States.

Anti-Money Laundering Steps Required

Under the proposed rule, if adopted in final form as proposed, private funds will be required to take the following affirmative steps to guard against money laundering:

Name an Anti-Money Laundering Compliance Officer. Under Treasury's proposed rule, private funds will be required to designate a Compliance Officer who will be responsible for AML compliance. This person must be competent and knowledgeable about money laundering issues and empowered to develop and enforce AML policies and procedures for the private fund. This person also should be an officer, trustee, general partner, organiser, or sponsor of the fund. As a general rule, funds run from the UK, whether regulated or not, do not have their own AML procedures in place, although their managers and administrators do, but to comply with local law and regulations and not the Patriot Act .

Establish an Anti-Money Laundering Programme. Private funds will be required to establish AML programmes (or, in UK parlance, compliance procedures). At a minimum, such programmes must be written; approved by fund boards of directors/ trustees, general partners or, if the foregoing do not exist, senior management; and include (1) internal policies, procedures and controls; (2) ongoing employee training; and (3) independent testing of the implementation of the programme.

- *Internal Policies, Procedures, and Controls.* The internal policies, procedures, and controls should be tailored to address the money laundering risks faced by the particular fund. Such policies and procedures should be reasonably designed to detect activity indicative of money laundering, such as unusual wire activity; transfers to and from "high-risk" countries; non-economic transfers, such as purchases and immediate redemptions; and checks or wires drawn on accounts of third parties.

- *Ongoing Employee Training.* Employees of private funds and third-party service providers must be trained regarding anti-money laundering signs and requirements. The level, focus and frequency of training may vary based on personnel function.

- *Independent Testing.* An independent test of the programme should be conducted periodically and findings should be reported to the board, general partner or senior management, as appropriate. Although the proposed rule requires periodic testing, it does not mandate a minimum auditing cycle. Tests should result in written reports, and recommendations from such reports should be implemented or shared with fund general partners, with boards or at other similar levels for consideration.

Notify Treasury. The proposed rule would require each private fund to submit to Treasury a short notice identifying itself and providing other basic information (including name, address, dollar amount of assets under management, and the number of participants/investors in the fund). Without such notice, Treasury would have no way of identifying private funds subject to the rule to assure their compliance with these requirements.

Delegation of Responsibility

The Treasury proposal permits private funds to delegate contractually certain AML functions to third parties, such as fund administrators or investment advisers. A private fund, however, may not absolve itself from AML responsibility by means of such delegation; the fund remains responsible for assuring its AML compliance.

In addition, if a fund delegates the implementation and operation of aspects of its AML programme to a third party service provider, the fund is responsible for ensuring that US government examiners are able to (a) obtain information and records from that delegate, and (b) inspect the third party delegate. This requirement could be highly problematic for offshore administrators, which may be best positioned to carry out private fund anti-money laundering responsibilities for many funds but which may be reluctant to open their books and records to the US government. In addition, the ability of US examiners to review administrator books and records would appear to mean US government access to account-specific information, including information as to the names of fund shareholders. Obviously, this raises significant concerns under confidentiality laws and policies.

Treasury's Report to Congress on Funds

On New Year's Eve 2002, Treasury – in conjunction with the Federal Reserve and Securities and Exchange Commission – issued a report mandated by the Patriot Act on applying AML requirements to investment companies. The report gives some insight into how Treasury views hedge and other private funds and what further AML requirements may be forthcoming for such funds.

First, the report makes clear that Treasury believes that hedge funds are "susceptible to abuse by money launderers." The report notes that the complex structure of many hedge funds, the ability of investors to make anonymous investments in funds (often by structuring investments through offshore corporate feeders), and the frequent location of funds (or funds' books and records) in bank secrecy and tax haven jurisdictions makes hedge funds an inviting source of investment for money launderers.

Given this belief, the report makes clear that Treasury will not abandon its attempts to make hedge and other private funds subject to AML rules and regulations. Indeed, the report recommends requiring hedge funds and other private funds to establish customer identification and verification programmes.

In July 2002, Treasury issued proposed rules for mutual funds and other financial institutions (but *not* private funds) that set forth minimum standards for customer identification, verification and record keeping in the account opening process. These proposed rules proved highly controversial, as they required financial institutions affected by those rules to take a variety of detailed steps to verify the identity of their customers or investors prior to establishing a relationship with them. The rules were the subject of much negative industry criticism and, consequently, have not yet been finalised. Private funds should watch what form these customer identification rules take, as private funds in the future may need to comply with similar rules and may no longer be able to deal with undisclosed beneficial owners.

Summary

If you have any US investors in your fund, or if you intend to market your fund to US persons (irrespective of where they are located), or if you are a director or administrator of such a fund, you should be aware of the requirements the Patriot Act will impose on your fund and plan accordingly.

For further information contact:

London

4 Carlton Gardens, Pall Mall
London SW1Y 5AA
Facsimile: +44 (20) 7872-1095

Simon Firth +44 (20) 7872-1036
Simon.Firth@wilmer.com

Alix Prentice +44 (20) 7872-1064
Alix.Prentice@wilmer.com

Washington, DC

2445 M Street, N.W.
Washington, DC 20037
Facsimile: +1 (202) 663-6363

Satish Kini +1 (202) 663-6482
Satish.Kini@wilmer.com