

MARCH 11, 2002

## ANTI-MONEY LAUNDERING – APPLICATION TO PRIVATE INVESTMENT FUNDS

Due to recently enacted changes to the Bank Secrecy Act (“BSA”), investment companies will now be subject to enhanced scrutiny, including possibly the mandatory reporting requirements of the BSA. Importantly for the sponsors and managers of private investment funds, the new anti-money laundering regulations may require private investment funds to establish an anti-money laundering compliance program by April 24, 2002.

### The USA Patriot Act

On October 26, 2001, anti-terrorism legislation known as the Uniting and Strengthening America Act by Providing Appropriate Tools Required to Intercept & Obstruct Terrorism (USA Patriot) Act of 2001 (the “Act”) was passed into law implementing significant changes to the BSA. The Act was passed in response to concerns that the September 11<sup>th</sup> attacks may have been financed through United States financial institutions and in response to American lawmakers desire to stop the flow of terrorist funds around the world. Of particular significance is Title III of the Act entitled the International Money Laundering Abatement and Anti-Terrorist Financing Act of 2001 (“Title III”), which imposes significant new anti-money laundering requirements on all financial institutions, including investment companies.

As mentioned above, Title III amends the BSA and provides the Treasury Department and federal agencies with enhanced authority to combat international money laundering by mandating more extensive reporting and record keeping requirements. In particular, Section 352 of the Act expands the scope of the BSA to require all financial institutions, including investment companies, to establish an “Anti-Money Laundering Program” by April 24, 2002. Such compliance program, will at a minimum, need to include the following procedures:

- (i) development of internal policies, procedures and controls by the investment company;
- (ii) designation of a compliance officer by the investment company;

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1285 Avenue of the Americas  
New York, New York 10019-6064  
(212) 373-3000

1615 L Street, NW  
Washington, DC 20036-5694  
(202) 223-7300

Alder Castle, 10 Noble Street  
London EC2V 7JU England  
(44-20) 7367 1600

2, rue du Faubourg Saint-Honoré  
75008 Paris, France  
(33-1) 53.43.14.14

Fukoku Seimei Building 2<sup>nd</sup> Floor  
2-2, Uchisawaicho 2-chome  
Chiyoda-ku, Tokyo 100, Japan  
(81-3) 3597-8120

2918 China World Tower II  
No. 1, Jianguomenwai Dajie  
Beijing 100004, People's Republic of China  
(86-10) 6505-6822

12<sup>th</sup> Fl., Hong Kong Club Building  
3A Chater Road, Central  
Hong Kong  
(852) 2536-9933

(iii) establishment of an ongoing employee training program by the investment company; and

(iv) implementation of an independent audit function to test the investment company's anti-money laundering program.

Also contemplated by the Act is the implementation of a "know your investor" program that will ensure that at the time an investor is permitted to enter into a fund, sufficient information is obtained about the investor so that a proper assessment can be made by the fund manager regarding the client's background and the source of the client's capital commitment to be invested into the fund.

Before April 24, 2002, the Secretary of the Treasury is expected to issue detailed regulations concerning the implementation of Section 352. The Act gives certain discretion to the Secretary of the Treasury to exempt entities that have not been designated as "financial institutions" under the BSA regulations from these BSA reporting requirements and the compliance program requirements, as described above. Therefore, while it currently appears that "investment companies" are covered by the regulations, it is not certain that private investment funds will ultimately be included within these regulations. However, if the Secretary of the Treasury does not exempt private investment funds from the definition of "financial institutions" prior to the April 24, 2002 deadline, this requirement will automatically become effective and severe penalties may be imposed against private investment funds that do not comply with these requirements.

Furthermore, private investment funds may eventually become even more directly impacted by Title III, particularly due to Section 356 of the Act. This Section requires the Treasury Department, the Federal Reserve Board and the Securities and Exchange Commission to jointly submit a report to Congress by October 26, 2002 on the potential use of investment companies as sources for money laundering and on recommendations for effective regulations to apply the requirements of the BSA to investment companies. For purposes of Section 356, Congress has made it clear that in composing its report, investment companies shall include both registered and unregistered investment companies under the Investment Company Act of 1940.

### **Initial Compliance Steps**

Although it is still unclear exactly what measures need to be taken to comply with the Act, industry professionals are eventually expected to reach an agreement on a common compliance standard. At the very least, a private investment fund can begin implementing the following compliance steps:

1. Evaluate investors' accounts to see whether the fund is maintaining and managing accounts with a foreign institution that does not have a physical presence in any country;

2. Obtain written guaranties from investors in their subscription agreements that capital contributions to the fund are not obtained from activities that violate any federal or state regulations, including anti-money laundering laws and Office of Foreign Assets Control Regulations (“OFAC”);

3. Compare the fund’s client information to OFAC’s list of prohibited foreign governments and agents;

4. Do proper diligence on investors’ bank accounts to assure that those funds are not being used to fund operations of a “shell bank;” and

5. Monitor the investors’ accounts and report suspicious financial activities.

### **Conclusion**

With the passage of the Act and its various regulations, all financial institutions, including private investment funds, can expect that regulators will focus on the laws new, more detailed, requirements. Given the sizable penalties and the regulator’s inclination to enforce them due to the current political climate, it is important that private investment funds begin implementing substantive anti-money laundering policies to meet the new regulations and avoid becoming investment vehicles for money launderers.

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We will continue to monitor any developments in the Act and keep you informed of such developments. Should you require any additional information, please feel free to contact Robert M. Hirsh, Steven R. Howard, Marco V. Masotti or Todd S. Greenberg at 212-373-3000.