Client ALERT

September 2002

FinCEN Proposes Anti-Money Laundering Regulation Applicable to "Unregistered Investment Companies"

Pursuant to the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (the "Patriot Act"), on September 18, 2002, the Financial Crimes Enforcement Network ("FinCEN") of the Department of the Treasury ("Treasury") proposed new anti-money laundering Rule 132 (the "Rule") under the Bank Secrecy Act (the "BSA") that would require "unregistered investment companies" ("Funds") to establish anti-money laundering programs. The proposed definition of unregistered investment companies is very broad, and includes certain commodity pools, companies that invest in real estate, and investment companies exempt from registration under the Investment Company Act of 1940 (the "1940 Act"). The proposed requirements are substantially the same as those FinCEN has established for mutual funds.[1]

FinCEN has merely proposed the Rule and requested comments on it – Funds are not currently required to do anything to comply with the proposed Rule. The proposed Rule would require that, within 90 days following publication of a final Rule, each Fund develop and implement its anti-money laundering program. FinCEN is accepting comments on the proposal until approximately November 15, 2002. Paul Hastings would be pleased to answer any questions you have about the Rule, and if appropriate, prepare and submit comments on the proposed Rule.

Who is Covered?

The Definition. The Rule proposes to define an "unregistered investment company" as:

- an issuer that, but for the exclusions provided in sections 3(c)(1) and 3(c)(7) of the 1940 Act, would be an investment company under the 1940 Act,
- a commodity pool as defined in Rule 4.10(d) under the Commodity Exchange Act, or
- a company that invests primarily in real estate and/or interests therein.

This definition generally would include entities primarily investing in one of the following asset classes: securities, commodity interests or real estate.

The Limitations. There are three limitations on the types of entities covered by the Rule – an "unregistered investment company" would include only those investment companies that:

- give an investor the right to redeem any portion of his or her ownership interest in the company within two years after that interest was purchased,
- as of the most recently completed calendar quarter have total assets of $1,000,000 or more (thus probably excluding most investment clubs and other small entities not likely to be used for money laundering), and
- are organized under the laws of the United States, or sell ownership interests to a "U.S. person" as defined in Regulation S under the Securities Act of 1933 even if organized overseas under foreign laws, or are organized, operated or sponsored by a U.S. person.

The Exceptions. The Rule also excepts four types of investment companies from the requirements of the Rule, including:

- companies owned by one family as defined in Section 2(a)(51)(A)(ii) of the 1940 Act (*i.e.*, companies that own not less than $5,000,000 in investments and that are beneficially owned by two or more natural persons related as siblings or spouses and their direct lineal descendants by birth or adoption and certain trusts or foundations established by or for the benefit of such persons) without regard to the amount of assets owned by such companies,
- employees' securities companies as defined under Section 2(a)(13) of the 1940 Act (*i.e.*, certain pooled investment vehicles established by employers for the benefit of employees),
- employee benefit plans that are not construed to be pools under Rule 4.5(a)(4) under the Commodity Exchange Act (*e.g.*, certain noncon-

tributory plans, governmental plans, employee welfare benefit plans or church plans), and

- companies that are also another type of "financial institution" under the BSA, such as broker-dealers.

Comments to FinCEN. In its proposing release, FinCEN went to great lengths to explain the reasons behind the scope of the definition and each limitation and exception. FinCEN also specifically solicited comments on whether the definitions, exceptions and limitations should be revised before being made effective, and whether additional limitations or exceptions should be added.

When thinking about the Rule, we recommend that clients be careful to construe the existing limitations and exceptions narrowly, and not assume that they will be exempt from the requirements of the Rule. Please contact us if you have any questions about ambiguities or inappropriateness in the scope of the definitions. We may, if appropriate, bring them to FinCEN's attention during the Rule's comment period, which ends on approximately November 15, 2002. For example, does the Rule apply to an offshore fund that is organized, sponsored and administered by a non-U.S. person, but that is advised by a U.S. adviser? Does the Rule actually apply to a real estate fund wholly owned and managed by two unrelated persons if it has assets greater than $1 million (perhaps there should be a limitation or exception based on the number of beneficial owners)? Is the two-year redemption limitation the appropriate time period, and would Fund management's discretion to allow redemptions within that period vitiate the limitation?

What is Required?

The proposed Rule sets forth minimum requirements for an anti-money laundering program for Funds.

First, companies must establish and implement policies, procedures and internal controls reasonably designed to prevent Funds from being used to launder money or finance terrorist activities, including but not limited to achieving compliance with the applicable provisions of the BSA and the implementing regulations thereunder.

Each Fund should identify its vulnerabilities to money laundering and terrorist financing activity, understand the BSA requirements applicable to it, identify the risk factors relating to these requirements, design the procedures and controls that will be required to reasonably ensure compliance with these requirements, and periodically assess the effectiveness of the procedures and controls. Funds will in essence be required to establish a paper trail showing that they obtained information leading them to reasonably believe that subscriptions are not being invested for laundering purposes. Treasury made clear that the requirement to have an anti-money laundering program is not a one-size-fits-all requirement – each financial institution has the flexibility to tailor its program to fit its business, taking into account factors such as size, location, activities and risks or vulnerabilities to money laundering.

Funds with offshore operations in or with investors from jurisdictions on lists maintained by the Office of Foreign Asset Control (sanctioned countries), FinCEN (country advisories), or the Financial Action Task Force on Money Laundering (non-cooperative countries and territories) should be particularly sensitive to these requirements. Note that the proposed rule does not prohibit Funds from doing business with foreign persons, even from sanctioned countries – it does, however, require companies to take extra care in dealing with such persons.

A Fund that identifies suspicious activity must take reasonable steps to determine if its suspicions are justified and respond accordingly. The response could include refusing to enter into a transaction that appears designed to further illegal activity. Note that it is a crime for any person, including an individual or company, to engage knowingly in a financial transaction with the proceeds from any of a long list of crimes or "specified unlawful activity," and that "knowingly" includes not only "actual knowledge" but also "willful blindness."

FinCEN has stated that Funds may contractually delegate the implementation and operation of aspects of their anti-money laundering programs to third parties, such as fund administrators, investment advisers and broker-dealers. However, a Fund will remain fully responsible for its program, including its effectiveness, and for ensuring that federal examiners are able to obtain information and records relating to the program and to inspect any third party for purposes of the program. It will not be sufficient for a Fund merely to obtain certifications from its service providers that they maintain adequate anti-money laundering policies in place – the Fund should consider what steps it must take to ensure that the service providers maintain adequate policies.

Each Fund's program must be approved in writing by the board of directors or trustees, the general partner or, if the foregoing do not exist, senior management, at their first regularly scheduled meeting after the program is adopted.

Second, companies must provide for independent testing of compliance to be conducted by company personnel or by a qualified outside party so long as

those same employees are not also involved in the operation or oversight of the program.

Funds must periodically test their programs to ensure that the programs are functioning as designed. Such testing should be accomplished by personnel knowledgeable about relevant money laundering risks as well as BSA requirements. The frequency of such a review would depend upon factors such as the size and complexity of the Fund's operations and the extent to which its business model may make it more vulnerable to money laundering than other institutions. A written assessment or report should be a part of the review, and any recommendations resulting from such review should be promptly implemented or submitted to the general partner, board of directors or trustees, or, if the foregoing do not exist at the Fund, senior management, for consideration. The requirement that the company personnel responsible for the compliance testing function be separate from those responsible for operating the anti-money laundering program may make it necessary for smaller firms to retain outside compliance testing assistance.

Third, companies must designate a person or persons responsible for implementing and monitoring the operations and internal controls of the program.

Each Fund must charge an individual (or committee) with the responsibility for overseeing the anti-money laundering program. The person (or group) should be competent and knowledgeable regarding BSA requirements and money laundering issues and risks, and empowered with full responsibility and authority to develop and enforce appropriate policies and procedures throughout the company. Whether the compliance officer is dedicated full time to BSA compliance would depend upon the size and complexity of the company. Although in some cases the implementation and operation of the compliance program will be conducted by entities (and their employees) other than the Fund, the person responsible for the supervision of the overall program should be a Fund officer, trustee, general partner, organizer, operator or sponsor, as appropriate.

Fourth, companies must provide ongoing training for appropriate persons regarding the BSA requirements that are relevant to their functions and the signs of money laundering that could arise in the course of their duties.

Such training can be conducted by outside or in-house seminars, and can include computer-based training. The level, frequency and focus of the training would be determined by the responsibilities of the employees and the extent to which their functions bring them in contact with BSA requirements or possible money laundering activity. Consequently, the training program should provide both a general awareness of overall BSA requirements and money laundering issues, as well as more job-specific guidance regarding the particular employee's role and function in the anti-money laundering program. For those employees whose duties bring them in contact with BSA requirements or possible money laundering activity, the requisite training should occur when the employee assumes those duties. Appropriate topics for an anti-money laundering program include, but are not limited to, BSA requirements, a description of money laundering, how money laundering is carried out, what types of activities and transactions should raise concerns, what steps should be followed when suspicions arise, and the Office of Foreign Assets Control and other government agency lists.

Fifth, each Fund must file a short notice identifying itself and providing some very basic information about the company.

The notice would be required to include: (1) the name, address, e-mail address and telephone number of the Fund; (2) the name, address, e-mail address, telephone number and registration number of any investment adviser, commodity trading advisor, commodity pool operator, organizer or sponsor of the Fund; (3) the name, e-mail address and telephone number of the designated anti-money laundering program compliance officer; (4) the dollar amount of assets under management held by the Fund; and (5) the number of participants, interest holders or security holders in the Fund.

A Fund would have to file the notice by accessing FinCEN's website or by mail within 90 days after it first becomes subject to the provisions of the Rule, and file amendments not later than 30 days after any change to the information in the notice *other than* the amount of assets under management or the number of participants, interest holders or security holders. A Fund would have to withdraw its notice within 90 days after ceasing to be subject to the Rule. Finally, the proposing release encourages Funds to adopt procedures for voluntarily filing Suspicious Activity Reports with FinCEN and for reporting suspected terrorist activities to FinCEN.

What Paul Hastings Can Do

Our investment management lawyers have substantial experience counseling clients in anti-money laundering compliance. If you have any questions concerning this or any other matter, please contact any one of us.

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[1] On September 18, 2002, Treasury issued other proposed and final rules not addressed by this Alert related to anti-money laundering, including (1) a final rule with respect to correspondent accounts maintained by U.S. banks and securities brokers on behalf of foreign banks, (2) a final rule that establishes a mechanism for law enforcement to request information of financial institutions and encourage information sharing, (3) a proposed rule requiring insurance companies to establish anti-money laundering programs, and (4) a final rule with respect to casinos and card clubs. This Alert also does not address recently issued anti-money laundering rules applicable to other types of financial institutions, such as registered investment companies (both open and closed end), broker-dealers and banks. However, we are familiar with these other releases – please contact us if you have any questions about them.