

BOSTON
WASHINGTON
NEW YORK
RESTON
NEW HAVEN

www.mintz.com

*One Financial Center
Boston, Massachusetts 02111
617 542 6000
617 542 2241 fax*

*701 Pennsylvania Avenue, N.W.
Washington, D.C. 20004
202 434 7300
202 434 7400 fax*

*666 Third Avenue
New York, New York 10017
212 935 3000
212 983 3115 fax*

*11911 Freedom Drive
Reston, Virginia 20190
703 464 4800
703 464 4895 fax*

*157 Church Street
New Haven, Connecticut 06510
203 777 8200
203 777 7111 fax*

Client Alert

March 2002

BUSINESS AND FINANCE

Federal Legislation Update: The USA PATRIOT Act and Applicability of Anti-Money Laundering Rules to Private Investment Companies/Funds

The "Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001" (USA PATRIOT Act) was signed into law by President Bush on October 26, 2001. Title III of the USA PATRIOT Act is the International Money Laundering Abatement and Anti-Terrorist Financing Act of 2001 (the "2001 Money Laundering Act"), which is intended to strengthen the anti-money laundering provisions of earlier legislation, particularly with respect to crimes by foreign nationals and foreign financial institutions, by imposing new and more stringent anti-money laundering laws. The 2001 Money Laundering Act amends certain provisions of, and adds new provisions to, the Bank Secrecy Act of 1970 (the BSA).¹ These amended and new provisions impose significant new anti-money laundering requirements on all "financial institutions," including investment companies,² which may be applied to private investment funds in regulations forthcoming under the 2001 Money Laundering Act. The 2001 Money Laundering Act expressly provides for an Investment Company Study to recommend whether to extend anti-money laundering rules and regulations applicable to financial institutions to investment companies such as private investment funds, and requires all financial institutions, likely including private investment funds, to establish anti-money laundering programs by April 24, 2002.

Background

The BSA, applicable to all financial institutions but most particularly to banks and broker-dealers, requires those organizations to maintain currency transaction records and file currency transaction reports for cash transactions in amounts aggregating more than \$10,000, and requires reporting of currency transactions into and out of the U.S. This requirement applies to investment companies as well. The BSA also requires banks and their affiliated broker-dealers to file suspicious activity reports regarding money laundering activity (many independent broker-dealers currently comply voluntarily with this requirement). The Department of the Treasury recently proposed regulations requiring *all* broker-dealers to file suspicious activity reports.³ As discussed below, it is likely that suspicious activity reporting requirements will be extended to investment companies as well. The Money Laundering Control Act of 1986 (the "1986 Money Laundering Act")⁴ made money laundering a crime, and added provisions to the BSA strengthening its impact. The 1986 Money Laundering Act applies

specifically to broker-dealers. Furthermore, SRO rules and NASD conduct rules applicable to member firms impose “Know Your Customer” requirements, which require firms to obtain basic information about customers opening accounts, such as beneficial ownership, address, employment, investment history, investment objectives, and source of funds. These rules will likely serve as the basis for “Know Your Customer” requirements which may be made applicable to private investment funds.

Investment Company Study

Prior to the passage of the USA PATRIOT Act, the BSA and the 1986 Money Laundering Act worked to outlaw money laundering and to impose related recordkeeping and reporting requirements on the financial institutions through which money laundering was thought to occur, but these requirements did not apply to private investment funds such as those operated by venture capital firms. Now, however, Section 356 of the 2001 Money Laundering Act provides for an investment company study to be completed by October 26, 2002 by the Secretary of the Treasury, the Federal Reserve’s Board of Governors, and the SEC containing recommendations for effective regulations to apply BSA requirements to “investment companies,” defined as any investment company under Section 3 of the Investment Company Act of 1940 (the ICA),⁵ **including registered investment companies and any person who would be an investment company but for the exceptions provided for in Sections 3(c)(1) and (7) of the ICA (the so-called “qualified purchaser fund” and “private investment fund” exceptions employed by many venture capital and private equity funds to avoid registration under the ICA).**⁶ The Investment Company Study may propose different regulations for different types of investment companies.

Overview of Money Laundering Act Provisions Which May be Applicable to Private Investment Funds

The recommendations set forth in the Section 356 study will clearly impact investment companies, and may extend to private investment funds such as venture capital funds. However, other provisions of the 2001 Money Laundering Act apply by their terms to all “financial institutions,” and the Department of the Treasury is charged with enacting regulations defining the scope of these provisions and their applicability to registered and unregistered investment funds. The Department of the Treasury has indicated to representatives of the National Venture Capital Association (NVCA) that it is likely to extend provisions of the 2001 Money Laundering Act to investment funds.⁷ The NVCA is recommending that member firms comply with those provisions of the USA PATRIOT Act that could be extended to private investment funds.⁸ Such provisions will likely include:

- Section 352 of the 2001 Money Laundering Act requires financial institutions to establish anti-money laundering programs, including at a minimum:
 - i) the development of internal policies, procedures and controls;
 - ii) the designation of a compliance officer;
 - iii) an ongoing employee training program; and
 - iv) an independent audit to test functions.

Despite the lack of Treasury regulations setting forth the minimum standards for anti-money laundering programs, Section 352 becomes effective on **April 24, 2002**. As indicated above, it is likely that both public and private investment funds will be required to establish such programs in compliance with Section 352.

- Section 326 of the 2001 Money Laundering Act requires the Department of the Treasury to issue regulations establishing minimum standards for customer identification, applicable to all customers opening accounts at financial institutions (“Know Your Customer” requirements). At a minimum, these regulations must require financial institutions to implement procedures for:
 - i) verifying the identity of any person seeking to open an account;
 - ii) maintaining records of the information used to verify a person’s identity; and
 - iii) cross-checking account-holder names against lists of known or suspected terrorists or terrorist organizations generated by government agencies.⁹

In prescribing the regulations, the Secretary of the Treasury may exempt any financial institution or type of account. The regulations must be released by October 26, 2002.

- Section 312 of the 2001 Money Laundering Act requires that each financial institution that establishes, maintains or manages a private banking or correspondent account in the U.S. for a non-U.S. person, shall establish due diligence policies, procedures and controls reasonably designed to detect and report instances of money laundering through those accounts. The statute sets forth minimum diligence steps financial institutions are required to take for each of private banking accounts (defined as an account or accounts for at least \$1 million administered by an agent of the financial institution acting as a liaison between the financial institution and the account owner) and correspondent accounts (defined as accounts established to receive deposits from, make payments on behalf of, or engage in other transactions related to a foreign financial institution).

The 2001 Money Laundering Act requires the Treasury to promulgate regulations relating to the due diligence policies and procedures by **April 24, 2002**. We will update this *Client Alert* as soon as the new regulations are available.

Other sections of the 2001 Money Laundering Act could also extend to private investment funds. Such funds should carefully monitor regulations set forth under the 2001 Money Laundering Act to assess applicability of their provisions to private investment funds.

NASD Proposed Rule 3011

The NASD has published proposed Rule 3011 requiring member firms to develop and implement, by April 24, 2002, written anti-money laundering programs reasonably designed to achieve and monitor compliance with the BSA and the implementing regulations promulgated by the Department of the Treasury. Proposed Rule 3011 is consistent with Section 352 of the 2001 Money Laundering Act and its standards are substantially equivalent to those found in existing bank anti-money laundering program rules. The NASD anticipates issuing guidance to members to assist them in developing anti-money laundering programs applicable to their business model and needs.

Recommendations

Because of the uncertainty, pending the release of implementing regulations, regarding the scope of the applicability of the anti-money laundering provisions of the USA PATRIOT Act to private investment funds, we recommend compliance by such funds in order to ensure that they do not unwittingly engage in, or assist others in engaging in, money laundering activities. At a minimum, private investment funds should:

- Establish by April 24, 2002 an anti-money laundering program, including a statement of the organization's commitment to comply with applicable laws and regulations; emphasize the responsibility of employees to monitor transactions and ensure compliance; and establish written procedures regarding the organization's means of detecting and preventing money laundering, including monitoring of accounts and heightened scrutiny of specific persons, accounts and transactions. The procedures should be designed to ensure compliance with the new laws and regulations applicable to private investment funds.
- Designate a compliance officer to monitor compliance and serve as an intermediary with regulatory authorities.
- Establish "Know Your Customer" procedures requiring personnel to gather and maintain records of investor information and to assess the investor's business and background and source of investment funds and the investor's investment objectives. Organizations should check investor and third party names against the Office of Foreign Asset Control's lists of suspected terrorists and other lists maintained by the State Department, Treasury Department and the Commerce Department, and should require investors to certify that capital contributions are not derived from activities prohibited by applicable anti-money laundering laws and regulations.
- Establish procedures to assist in identifying suspicious or unusual transactions, train employees regarding the legal requirements and how to identify such suspicious transactions, and delineate specific internal reporting channels and methods.
- Report suspicious activity¹⁰ (*Section 351 of the USA PATRIOT Act provides a safe harbor from liability to any person, under federal or state law or any private agreement, for financial institution employees voluntarily disclosing possible violations to a government agency*).

- Develop an internal audit program to ascertain compliance with anti-money laundering policies, Know Your Customer procedures, and suspicious activity reporting standards.
- Monitor USA PATRIOT Act implementing regulations when issued to assess applicability to investment companies.

In the absence of specific regulations promulgated by the Department of the Treasury, investment companies seeking guidance with regard to the establishment of anti-money laundering programs, Know Your Customer procedures and suspicious activity monitoring and reporting policies can look to the NVCA's guidelines for member organizations, expected to be issued prior to April 24, 2002. Furthermore, other industry and government groups have released, or will release, guidelines applicable to other types of entities, such as the NASD and the Securities Industry Association.¹¹

* * * * *

If you have any questions regarding the applicability of the 2001 Money Laundering Act to your Company, please contact Mark Chamberlin at 617-348-1840 or Jessica Bettencourt at 203-787-6335. If you have questions about, or need assistance with, establishing a screening program against the various prohibited entities and persons lists, please contact Cynthia Larose at 617-348-1732.

¹ 31 U.S.C. § 5311 et seq.

² 31 U.S.C. § 5312 includes broker-dealers and investment companies in the definition of financial institutions.

³ See 31 C.F.R. Part 103 (December 31, 2001), available on the website of the Financial Crimes Enforcement Network ("FinCEN")(www.ustreas.gov/fincen/), a division of the Department of the Treasury charged with enforcing the money laundering laws.

⁴ 18 U.S.C. §§ 1956 and 1957. These sections prohibit financial transactions intended to conceal the source or nature of funds generated by criminal activity and transactions involving funds derived from criminal activity. Violations of the MLCA can result in fines amounting to the greater of \$500,000 or two times the value of the property, and a prison term of up to twenty years.

⁵ 15 U.S.C. § 80a-3.

⁶ Section 356 also requires the Secretary of the Treasury, in consultation with the SEC and the Federal Reserve's Board of Governors, to establish regulations by July 1, 2002 requiring broker-dealers to file reports of suspicious financial transactions. Proposed regulations have already been issued. Depending upon the recommendations in the Investment Company Study, suspicious activity reporting requirements could be extended to private investment funds as well.

⁷ Conversation with Brian Borders, SEC Counsel of NVCA, March 8, 2002.

⁸ See NVCA Legislative Update, February 22, 2002.

⁹ The Office of Foreign Assets Control (OFAC) administers sanctions programs including prohibitions against trading with enemies of the U.S., as set forth on various lists of known and suspected terrorists prepared by OFAC and other government agencies. Private investment firms are already required to comply with these sanctions.

¹⁰ Such activity could include, for example: transactions in funds derived from illegal activity or intended to hide funds or assets derived from illegal activity; transactions designed to evade the BSA and applicable regulations; transactions serving no apparent business purpose, for which there are no reasonable explanations, or which are inconsistent with the investor's investment strategy; transactions with regard to which the investor exhibits a lack of concern regarding the risks, commissions or transaction costs; an investor who exhibits unusual concern for secrecy; frequent transfers to and from foreign accounts; numerous wire transfers from offshore sources; or multiple subscriptions to the fund. Note that there are strict confidentiality requirements applicable to suspicious activity report filings.

¹¹ For example, on February 12, 2002, the SIA's Anti-Money Laundering Committee issued Preliminary Guidance for Deterring Money Laundering Activity, available on the SIA's website, www.sia.com. The NASD also anticipates issuing compliance guidelines for members.