ANTI-MONEY LAUNDERING COMPLIANCE AND PRIVATE INVESTMENT FUNDS

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APRIL 9, 2002

On October 26, 2001, President Bush signed into law the USA PATRIOT Act[1] which was designed to give the United States government new powers in its fight against terrorism. Title III of the USA PATRIOT Act, the International Money Laundering Abatement and Anti-Terrorist Financing Act of 2001 (the "Act"), imposes new anti-money laundering requirements on financial institutions[2], including private equity funds and hedge funds (collectively, "funds") and their managers[3]. Under the Act, United States courts will have jurisdiction over all domestic financial institutions and foreign financial institutions which maintain bank accounts in the United States or who are knowing parties to financial transactions, which occur in whole or in part in the United States, in connection with certain money laundering activities.

The Act requires financial institutions to adopt by *April 24, 2002* an anti-money laundering program which must include the following: (i) internal anti-money laundering policies, procedures and controls; (ii) designation of a compliance officer to monitor compliance with such program; (iii) an ongoing employee training program; and (iv) an independent audit function to determine compliance with the program. The purpose of this memorandum is to provide guidance to funds and their managers in complying with the Act, including the adoption of compliance programs.

Unfortunately, the Act itself provides little guidance regarding the proper design or operation of an anti-money laundering program and there are many unanswered questions regarding the scope and application of the Act's requirements to funds and their managers. While implementing regulations are due to be issued later this year that should set forth specific

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1 The Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001, Pub. L. No. 107-56 (2001). The USA PATRIOT Act amends existing U.S. laws on money laundering, including the Bank Secrecy Act, 31 U.S.C. §§ 5311 *et seq*.

2 "Financial institutions" includes registered and unregistered investment companies and commodity trading advisors ("CTAs") and commodity pool operators ("CPOs") which are registered or required to register with the Commodity Futures Trading Commission (the "CFTC").

3 Although not specifically included in the Act as "financial institutions," investment advisors will need to ensure compliance with the Act by the investment vehicles they manage.

details regarding the requirements of an anti-money laundering program,[4] funds and their managers must comply with the Act's requirements even before the implementation of such clarifying regulations. Accordingly, a fund should establish an anti-money laundering program now and should regularly review and update its program to conform to future regulations under the Act, as well as to changes in its business and operations.

Funds should make compliance with the Act, including the adoption of the anti-money laundering program by April 24, 2002, a top priority. The suggestions below should be considered in light of the size, structure and resources of the fund, the types of investors in the fund and the private investment fund industry's evolving approach to anti-money laundering compliance.

I. INTERNAL POLICY

Each fund should adopt a written internal policy which outlines the procedures and controls through which the fund will detect and prevent money laundering and comply with the Act. The policy should be circulated to all employees and should include a broad mission statement which describes the commitment of the fund and its management to comply with all rules and regulations designed to fight money laundering, emphasizes the responsibility of all employees to prevent money laundering and outlines the significant penalties, both legal and reputational, that may result from any association with money laundering.

Funds should consider discussing the following procedures in the policy:

A. "KNOW YOUR CUSTOMER"

Each fund should set out in its money laundering policy "Know Your Customer" procedures, which will be used by the fund to ascertain the identity of prospective and actual investors.

[4] By April 24, 2002, the Secretary of the Treasury may prescribe minimum standards for anti-money laundering programs and must prescribe regulations that consider the extent to which the anti-money laundering requirements are commensurate with the size, location and activities of financial institutions. By October 26, 2002, the Secretary of the Treasury (the "Secretary"), the Securities and Exchange Commission and the Federal Reserve must submit a joint recommendation to Congress on the applicability of certain anti-money laundering requirements of the Bank Secrecy Act to registered and unregistered investment companies. In addition, the Secretary, after consultation with CFTC, may prescribe minimum standards for the anti-money laundering programs of CPOs and CTAs.

1. Due Diligence

The policy should emphasize the importance of conducting due diligence on any investor. The policy should direct fund employees to consider the following when evaluating an investor:

(a) Whether the investor is politically prominent and whether the transaction may involve proceeds from foreign corrupt practices or other illegal activities.

(b) Whether the investor's business dealings are high risk. Some examples of high-risk business activities are those that are cash intensive, involve non-traditional financial entities or the import/export business.[5]

(c) Whether the investor's country of residence or citizenship could be considered a high-risk jurisdiction for money laundering or other financial crimes. Some factors to consider in this determination are:

(i) whether the country appears on the Financial Action Task Force on Money Laundering ("FATF") list of Non-Cooperative Countries or Territories ("NCCTs")[6] or is not otherwise subject to adequate money laundering controls;

(ii) whether the country has implemented appropriate strategies to combat terrorist financing[7];

(iii) whether the country is identified in advisories released by the Financial Crimes Enforcement Network ("FinCEN") of the United States Department of the Treasury[8];

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[5] Funds may wish to consult the Denied Persons List of the Department of Commerce, which lists persons denied export privileges and is available on the Internet at http://www.bxa.doc.gov, as one way of determining whether an investor's business dealings are high risk.

[6] FATF is an inter-governmental body whose purpose is the development and promotion of policies to combat money laundering. NCCTs are those countries which do not currently cooperate with FATF's fight against money laundering and exhibit weaknesses in their anti-money laundering programs. FATF's list of NCCTs, as well as the relevant FATF statements and documents on NCCTs, is available on the Internet at http://www1.oecd.org/fatf/NCCT_en.htm.

[7] In June 2002, FATF will begin a process by which it will identify countries that lack appropriate measures to combat terrorist financing. Funds should monitor the FATF website (http://www1.oecd.og/fatf) for further information about these jurisdictions.

[8] FinCEN publishes advisories and reports on its website (http://www.ustreas.gov/fincen) relating to money laundering around the world. Funds should visit this website regularly to determine whether

(iv) whether the country is considered a "Jurisdiction of Primary Concern" by the Bureau for International Narcotics and Law Enforcement Affairs of the United States Department of State[9];

(v) whether the country is categorized as a Group III Offshore Financial Center by the Financial Stability Forum;[10] and

(vi) whether the country grants "economic" citizenships.[11]

(d) Whether the investor appears in any of the following watchlists:

(i) the Annex to United States Executive Order 132224 –Blocking Property and Prohibiting Transactions with Persons Who Commit, Threaten to Commit, or Support Terrorism ("Executive Order 132224")[12]; or

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countries with which they do business have adequate anti-money laundering controls and whether there are FinCEN recommendations or rulings with which they should comply.

9 The Bureau for International Narcotics and Law Enforcement Affairs releases an annual International Narcotics Control Strategy Report ("INCSR") which identifies those countries that are considered "major money laundering countries," *i.e.*, jurisdictions whose financial institutions are parties to transactions involving significant amounts of proceeds from serious crimes. The 2001 INCSR is available on the United States Department of State website (http://www.state.gov/g/inl/rls/nrcrpt/2001/rpt/8487.htm).

10 The Financial Stability Forum issued "The Report of the Working Group on Offshore Financial Centers" on April 5, 2000, in which it categorized the following jurisdictions as Group III Offshore Financial Centers: Anguilla, Antigua and Barbuda, Aruba, Belize, British Virgin Islands, Cayman Islands, Cook Islands, Costa Rica, Cyprus, Lebanon, Liechtenstein, Marshall Islands, Mauritius, Nauru, Netherlands Antilles, Niue, Panama, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, Samoa, Seychelles, the Bahamas, Turks and Caicos and Vanuatu. The financial institutions in these jurisdictions did not have satisfactory supervisory oversight, did not substantially adhere to international standards for financial institutions and lacked transparency. The Report is available on the Financial Stability Forum website at (http://www.fsforum.org/Reports/RepOFC01.pdf).

11 "Economic" citizenships may be purchased from the granting jurisdiction. Individuals often purchase such citizenships to avoid extradition to their home country and to change their names with their new passports. The 2001 INCSR identifies Belize, Dominica, St. Kitts & Nevis and Nauru as selling inadequately regulated "economic" citizenships and reports that members of terrorist groups have been known to purchase such citizenships.

12 Executive Order 132224 can be found on the Internet at http://www.ustreas.gov/ofac/t11ter.pdf.

(ii) the Specially Designated Nationals and Blocked Persons List[13] issued by the Office of Foreign Assets Control of the United States Department of the Treasury ("OFAC") or any subsequent watchlist issued by OFAC[14].

Additionally, the policy should instruct responsible employees to conduct internet and news database searches (using Lexis-Nexis, internet search engines or other databases) to determine whether an investor falls under the items listed above or otherwise raises money-laundering suspicions. The fund may wish to require approval of senior management to accept the subscription of any potential investor described in these items. The fund should work with its counsel to determine whether to accept or reject a subscription, whether to consider redeeming an investor's interest in the fund and/or whether to voluntarily file a Suspicious Activity Report ("SAR") with FinCEN.[15]

2. ***Identification and Recordkeeping***

The policy should require that fund employees obtain documentation relating to identification of individuals and formation and existence of entities in connection with acceptance of any subscription for interests in the fund. Copies of these records with respect to an investor, together with any paperwork relating to any due diligence by the fund with respect to such investor, should be retained for at least five years following the complete redemption or withdrawal of such investor from the fund. The fund should require different documentation from each investor, according to its structure. In the absence of regulations clarifying investor identification requirements, funds wishing to adopt a conservative approach to anti-money laundering compliance should consider the following:

(a) Individual Investors

For individual investors, the fund should request official identity documents and information, such as a driver's license with a photograph or a passport to establish the individual's identity and, additionally, with respect to U.S. persons, social security numbers.

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13 The list is available on the Internet at http://www.ustreas.gov/ofac/t11sdn.pdf.

14 OFAC is responsible for implementing Executive Order 132224 and may issue further regulations or publish additional watchlists. Any regulations or watchlists issued by OFAC can be found on the Internet at http://www.ustreas.gov/ofac/. Fund employees responsible for conducting due diligence should consult this website frequently to determine whether OFAC has issued additional regulations with which the fund must comply.

15 While investment companies, CPOs and CTAs are not currently required to file SARs (but may do so voluntarily), future regulations may impose such requirements.

(b) Trusts

Trusts should provide evidence of formation and existence, e.g., the trust agreement. In addition, each trust should provide information necessary to determine: (i) the source of the trust's funds, i.e. the identity of the settlor and/or grantor, (ii) the identity of anyone else with control over the trust's funds, i.e., trustees and individuals who have the power to remove trustees and (iii) the identity of the trust's beneficiaries.

(c) Corporate Vehicles

Corporate vehicles should provide the certificate of incorporation and bylaws. Such investors should provide the identities of directors, any persons with the power to direct the actions of the directors and significant shareholders.

(d) Limited Liability Companies

Limited liability companies ("LLCs") should provide the formation documents and copies of their operating agreements, in addition to any information necessary to determine the ultimate identity of the LLC's members and managers.

(e) Partnerships

Partnerships should provide formation documents, if applicable, and copies of partnership agreements, in addition to any information necessary to determine the ultimate identity of the partners.

(f) Employee Benefit Plans

Employee benefit plans should provide relevant organizational documents, e.g., a trust agreement.

Funds wishing to adopt a conservative approach to anti-money laundering compliance should consider looking through any beneficial owners which are entities (e.g., fund-of-funds) and conduct due diligence with respect to the ultimate individual beneficial owners of such entities in accordance with paragraph (a) above. See Section V, paragraph B below for a discussion of acceptability of investors' representations.

B. RECOGNITION OF SUSPICIOUS TRANSACTIONS

The policy should also discuss procedures for identifying suspicious transactions and should set forth examples of "red flags" in connection with initial subscriptions and subsequent transactions with the fund. Examples of suspicious transactions may include:

(i) an investor attempting to make payments with:

(a) cash, cash equivalents or other monetary instruments potentially used to avoid government reporting requirements or

(b) certain types of legitimate securities such as penny stocks, Regulation S securities or bearer bonds which have been historically used in association with money laundering activity;

(ii) an investor which is reluctant to reveal information concerning its business activities or has difficulty describing the nature of its business;

(iii) an investor which appears to be acting as an agent or nominee for another person but is reluctant to reveal information about such other person;

(iv) an investor which effects multiple transfers of funds;

(v) an investor which wires money from countries that are considered tax or bank secrecy havens or that are listed in any of the reports or advisories identified in Section A, paragraph 1(c) above;

(vi) an investor whose purchase of interests in the fund is quickly followed by a request to redeem, withdraw or transfer those interests to a third party;

(vii) an investor which requests that the fund process its subscription so as to avoid standard subscription and documentation procedures;

(viii) an investor which exhibits a complete disregard for risks, such as adverse tax treatment and transaction costs, does not conduct any due diligence in connection with its investment in the fund, lacks an apparent business strategy or behaves in a way that is inconsistent with its stated business strategy;

(ix) an investor wires funds in connection with a subscription and either the wire information differs in a material way from the wire information provided in such investor's questionnaire or the funds are wired through multiple accounts; and

(x) an investor which wires funds from an Islamic bank[16] or a "shell" bank[17].

[16] The 2001 INCSR states that Islamic banks are frequently used by terrorist groups because they prohibit the payment of interest and because they are often not subject to the same supervisory oversight as commercial banks.

[17] "Shell" banks are often registered in offshore jurisdictions but do not have a physical presence in any jurisdiction.

The policy should require employees to report any suspicious transactions to the compliance officer who should conduct further review of the investors and consult with senior management and counsel as to the appropriate action.

C. CONTRACTUAL REPRESENTATIONS

The policy should require employees handling the subscription of new investors to ensure that each investor has made representations to the fund which are similar to the following:

> "*Source and Use of Funds.* Neither the investor, nor any person having a direct or indirect beneficial interest in the interests to be acquired, appears on the Specially Designated Nationals and Blocked Persons List of the Office of Foreign Assets Control of the United States Department of the Treasury or in Annex I to United States Executive Order 132224 – Blocking Property and Prohibiting Transactions with Persons Who Commit, Threaten to Commit, or Support Terrorism. The investor further represents that the investor does not know or have any reason to suspect that (i) the monies used to fund the investor's investment in interests have been or will be derived from or related to any illegal activities and (ii) the proceeds from the investor's investment in interests will be used to finance any illegal activities.
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> *Further Advice and Assurances.* All information that the investor has provided to the fund, including the information in the investor questionnaire, is true, correct and complete as of the date hereof, and the investor agrees to notify the fund immediately if any representation, warranty or information contained in its subscription agreement, including in the investor questionnaire, becomes untrue at any time. The investor agrees to provide such information and execute and deliver such documents as the fund may reasonably request from time to time to verify the accuracy of the investor's representations and warranties herein or to comply with any law, rule or regulation to which the fund may be subject, including compliance with anti-money laundering laws."

II. COMPLIANCE OFFICER

The Act requires designation of a compliance officer to monitor the anti-money laundering program. The fund should determine, based on a consideration of its size, structure and resources, whether this officer will operate most effectively through a pre-existing department or group and whether he or she will be dedicated solely to anti-money laundering compliance. The officer should be the primary contact with regulatory agencies, law firms and auditing firms on issues relating to the fund's anti-money laundering program.

III. EMPLOYEE TRAINING PROGRAM

Each fund must establish a program to train all employees in the fund's procedures relating to money laundering. The program should focus on the fund's written policy and a copy of such policy should be provided to all employees. The fund should pay particular attention to the training of personnel who market and otherwise solicit subscriptions to the fund, as well as legal, treasury and audit personnel. Training can be conducted in a variety of ways, depending on the individual needs of the fund.

IV. INDEPENDENT AUDIT

The Act requires an independent audit program to ensure that a financial institution is complying with its internal anti-money laundering program. It is unclear at this time whether the Act mandates an outside audit or whether an internal audit conducted by employees independent from the compliance officer or compliance group may satisfy this requirement. If a fund decides that an outside audit is more appropriate, it may consider arranging for such audit to be part of the annual financial audit process conducted by an independent outside accounting firm.

V. OTHER ISSUES

A. PENALTIES

Potential penalties under the current anti-money laundering regime are severe. Financial institutions involved in money laundering may become subject to heavy financial penalties and criminal prosecution. In addition, financial institutions associated with such activities in the past have been subject to media publicity that may cause serious reputational damage.

B. DELEGATION AND RELIANCE

The Act does not discuss whether funds and their managers may comply with its requirements by delegating compliance responsibilities to third parties (e.g., fund administrators) or by relying solely on the representations of investors or the representations of nominees with respect to their beneficiaries. In light of the severity of possible penalties, each fund should be aware that the ultimate responsibility for compliance with and liability under the Act lies with the fund and its managers. Each fund should decide in consultation with its

counsel whether any delegation and reliance is appropriate given the nature of the fund's investors and its size and structure.[18]

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As noted above, private investment funds will be subject to additional anti-money laundering regulations and we will provide you with information about those regulations when they are announced. If you have any questions, please call Thomas Bell (212-455-2533, tbell@stblaw.com), Glenn Sarno (212-455-2706, gsarno@stblaw.com), Michael Wolitzer (212-455-7440, mwolitzer@stblaw.com), Olga Gutman (212-455-3522, ogutman@stblaw.com) or Rachael Clarke (212-455-2769, rclarke@stblaw.com).

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[18] If, after assessing the risks associated with relying on third parties to diligence investors, a fund decides that it wishes to rely on the services and/or representations of third-parties, it may consider taking certain precautions, including:

(a) using the services and relying on the representations of reputable financial institutions regulated by United States or other FATF-compliant jurisdictions; and

(b) requiring the third-party to covenant the following: (i) the third party has and complies with anti-money laundering procedures; (ii) the third party will look through any nominees or intermediaries to the ultimate beneficial owners, (iii) the third party will provide upon request by the fund records of the investor due diligence performed with respect to the fund's actual and potential investors; and (iv) the third party will submit to a review of its anti-money laundering policies and controls.