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Chapter Eight: USA PATRIOT Act: New Responsibilities for Hedge Fund Managers

*George J. Mazin and Paul Dunn,
Dechert LLP, New York*

The 11 September 2001 terrorist attacks have affected the lives of Americans in more ways than anyone could have imagined. One of the indirect consequences of the attacks is an increase in hedge fund managers' duties and responsibilities. In the aftermath of the attacks, the USA PATRIOT Act was signed into law. The Act seeks to curtail money laundering activities, and in doing so, it has affected the entire financial services industry. Significantly, Congress has enlisted the services of the actors in the financial world to help it detect money laundering and other suspicious financial activities. On 18 September 2002, the Treasury Department issued proposed rules subjecting hedge funds to the requirements of the Act (the Proposed Rules). Despite being proposed nearly five years ago, the rules are not yet final. What follows is a discussion of the impact the Act has had on the manager of a hedge fund.

Introduction — The USA PATRIOT Act

The USA PATRIOT Act (Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001) was signed into law on 26 October 2001, in the aftermath of the 11 September terrorist attacks on New York, Washington, DC, and Pennsylvania. The USA PATRIOT Act (the Act) enlarges the scope of US

anti-money laundering efforts. The goal is to fight international money laundering and block terrorists' access to the United States' financial system. Specifically, the Act amends the Bank Secrecy Act of 1970 (the BSA) to cover a broader range of financial institutions and activities and to increase the reporting and record-keeping obligations thereunder.

The BSA and money laundering

The BSA is a set of anti-money laundering provisions that was originally conceived to combat white-collar crime, drug-trafficking and the underground economy. It gave the Treasury Department broad discretion to require reports from financial institutions upon the occurrence of certain transactions that invite scrutiny because of the possibility that they are related to money laundering activity. One of the amendments to the BSA criminalized the structuring of transactions in order to avoid the BSA's reporting requirements. In 1986, Congress created the separate crime of money laundering, which applies to all persons — not just financial institutions.

Money laundering is the practice of engaging in acts designed to conceal the true origin of criminally derived funds so that they appear to have come from legitimate origins or constitute legitimate assets. The practice occurs in connection with a wide variety of crimes. Money laundering generally occurs in three stages:

Placement stage

Cash first enters the financial system; cash profits from criminal activity are converted into monetary instruments or deposited into accounts at financial institutions.

Layering stage

Funds are transferred into other accounts or financial institutions to further separate the proceeds from their criminal origin.

Integration stage

Funds are re-introduced into the economy and used to purchase assets or to fund further activities, whether legitimate or criminal.

Money laundering became a concern in the wake of 11 September 2001 because, as Congress found in passing the Act, money laundering is essential to the financing of international terrorism and the provision of funds for acts of terrorism. Thus, Congress and the President deemed it necessary to pass the Act and, in doing so, make use of its anti-money laundering provisions to combat terrorism.

Arguably, hedge funds are not very susceptible to money laundering activities. By way of comparison, hedge funds generally request far more detailed information from potential investors than do mutual funds. Hedge fund

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applications are ordinarily accompanied by an extensive questionnaire, enquiring into such information as net worth and income, investment experience, employment history, as well as other detailed information. Additionally, hedge funds offer less liquidity as a consequence of lock-ups and limited withdrawal rights. Finally, in the offshore world, enhanced money laundering procedures already have been the norm for several years.

Ultimately, however, the large amounts invested in hedge funds, the relative anonymity available to investors and the lack of government scrutiny, may offer the potential for abuse.

The USA PATRIOT Act

Both the scope and the ultimate substantive provisions of the Act are currently uncertain. However, under the Proposed Rules, the Treasury Department confirmed its position that hedge funds come within the BSA's definition of the term 'financial institution' and are therefore subject to the BSA's anti-money laundering, reporting and record-keeping obligations. Although more than four years have passed from the date the Proposed Rules were published, the Treasury has not yet issued final rules. Moreover, the Treasury and the Securities and Exchange Commission (SEC) have yet to issue 'know your customer' (KYC) rules (to be discussed below) in relation to hedge funds. As a result, the law in this area continues to be uncertain and will take shape over the coming years as rules are issued.

Substantively, the Act can be broken down into several distinct areas as discussed below.

Anti-money laundering programs

All covered financial institutions, including hedge funds, must establish and implement an anti-money laundering program. The program must consist of:

- development of internal policies, procedures, and controls for the detection and prevention of money laundering and terrorist activity;
- the designation of a compliance officer who is ultimately responsible for the implementation and continued efficacy of the program;
- the maintenance of an ongoing employee training program; and
- an independent audit function to test the adequacy of the program. The elements of the anti-money laundering program are discussed in further detail below.

KYC provisions

The Treasury Department (possibly in co-operation with other agencies) is expected to issue regulations setting forth minimum standards applicable to hedge funds for identifying and verifying the identity of customers who invest

in the fund. Such regulations have already been implemented for entities other than hedge funds, including mutual funds. The regulations must specify minimum standards for identifying customers, for verifying their identity at account opening, for maintaining records of the information used to verify the customer's identity, and for determining whether the customer appears on any US Government list of known or suspected terrorists.

Suspicious activity reports (SARs)

The Treasury Department has published regulations mandating that registered broker-dealers inside the United States, including US prime brokers, file reports on suspicious transactions. Mutual funds are also required to file SARs and the Proposed Rules indicate that hedge funds may become subject to such a requirement in the future.

Areas of 'primary money laundering concern'

The Treasury Department is also authorized to require financial institutions to take any of five different remedial actions when the Treasury determines that reasonable grounds exist to conclude that a foreign jurisdiction, a financial institution operating outside the United States, a class of international transactions, or one or more types of accounts is of 'primary money laundering concern'. Since the Treasury has not yet used this authority, the import of these provisions for hedge fund managers is unclear.

Information sharing and safe harbor provisions

The Treasury is directed to adopt regulations to encourage information sharing on suspected terrorists and/or money launderers between and among governments and financial institutions. The Act also provides for a 'safe harbor' from liability for sharing such information with others, whether voluntary or not.

Enforcement and penalty provisions

The Act also strengthens the enforcement of anti-money laundering laws and increases the civil and criminal penalties for violations of the laws. The Act provides for coverage of money-laundering activities that do not occur within the US, but would be illegal if committed within the US, and likewise punishes foreign nationals engaged in money-laundering activities in the US.

Notice filing

In order to assure compliance with the Act, the Proposed Rules require all covered hedge funds to file a notice with the Treasury's Financial Crimes Enforcement Network (FINCEN). The notice will require the disclosure of:

- the name of the fund and its address (including e-mail address) and telephone number;
- the name, address and telephone number, if applicable, and the registration number of the fund's

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adviser, commodity trading adviser, commodity pool operator, organizer and/or sponsor;

- the amount of the fund's assets; and
- the total number of participants.

The anti-money laundering program

The anti-money laundering program mandated by the Act consists of four elements:

- internal policies, procedures and controls;
- the appointment of a compliance officer to oversee the program;
- employee education and training; and
- an independent audit of the program.

Internal policies, procedures and controls

The first step in complying with the Act is to institute an anti-money laundering program. This, in turn, can be broken down into two steps:

- developing internal policies, procedures and controls geared towards the detection and prevention of money laundering and suspected terrorist activities; and
- implementing the policies and procedures as part of the day-to-day operations of the fund.

The policies and procedures should ultimately be produced in writing.

In developing the internal policies, procedures and controls, the most crucial thing for a hedge fund manager to understand is that the anti-money laundering program must be tailored to the particularities of the fund in question. This requires taking into account the nature of the fund's business, its investor base and the number of employees and agents of the fund. Fund managers cannot just adopt a boilerplate anti-money laundering program obtained 'off the shelf' or from another hedge fund; rather, they need to develop a program, and the incidental policies and procedures, suited to the fund in question. By examining the unique aspects of their own fund, they can identify the vulnerabilities of that fund to money-laundering potential and adopt policies and procedures appropriate to guard against laundering potential. Such policies and procedures might concern areas such as forms of payment accepted, redemption procedures, characteristics of investors accepted into the fund, and the administration of KYC procedures.

Generally, the fund manager should adopt a policy statement that clearly outlines the fund's policy against money laundering and a commitment to follow the applicable laws and regulations to ensure that the fund is

not a party to money-laundering activities. The policy statement should likewise state the fund's overall efforts to detect and prevent such illicit activity. It should contain statements showing a clear understanding and recognition of the importance of compliance with the laws that pertain to money laundering. This policy statement should also make clear that all fund employees have a responsibility to follow and help implement the fund's written anti-money laundering program, and to abide by the relevant laws and regulations, as well as the consequences that would follow a failure to do so.

If the fund is organized in an offshore jurisdiction, the procedures should recognize the obligation to also comply with the anti-money laundering rules in effect in such jurisdiction. In some cases, the fund may employ an administrator who administers the fund from another jurisdiction outside of the United States and the fund must comply with anti-money laundering laws in effect in such other jurisdiction.

The manager's procedures should enable fund employees to recognize suspicious customers and transactions, require them to report these persons and activities to the appropriate supervisory personnel (the program's compliance officer, to be discussed below), and ensure that the fund retains records to form an adequate audit trail in order to assist law enforcement agencies in an investigation. These specific procedures, as well as those for the training of fund employees and the independent audit of the anti-money laundering program, should likewise be produced in writing and included with the fund's policy statement.

Money laundering compliance officer (MLCO)

The manager is also required to designate and appoint a money laundering compliance officer or officers. The MLCO is ultimately responsible for the implementation and monitoring of the manager's anti-money laundering program. The MLCO can be a person or a committee, depending on the size of the manager, its investor base, and the nature and business of the manager and any affiliated businesses. The duties and role of the MLCO will depend on these same variables. A small fund with only a few investors could easily have just one MLCO who also has a variety of other duties, the function of serving as MLCO being just one of them. For a large fund, it may be a full-time function for one or more people to serve as the MLCO. But no matter what the size of the fund, there must be at least one MLCO. Sometimes, the duties of the MLCO may be split up. For instance, certain functions required to be performed under the anti-money laundering program may be conducted by service providers, with a representative of the manager ultimately responsible for the supervision of the overall program.

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The MLCO should be the central figure in the anti-money laundering program because this person has considerable discretion in performing the duties of the position. Specifically, the manager should consider designating the MLCO as the person to receive internal SARs from employees and to determine how much investigation into a matter is required. For example, how much diligence is required into an investor's identity, when to file an external SAR with the appropriate governmental authorities, and to what extent the manager can rely on the representations of investors or the representations provided by due diligence performed by third parties. Essentially, the MLCO should be conceived of as the 'gatekeeper'; it should be the ultimate arbiter in determining whether to accept or reject a subscription from any investor and whether to file an SAR.

The MLCO should be ultimately responsible for implementing and monitoring the anti-money laundering program of the manager. Some of the more specific responsibilities include monitoring the day-to-day operation of the program, receipt of SARs from employees, and taking reasonable steps to access any relevant information about fund clients in the exercise of due diligence, if deemed appropriate by the MLCO. Further, the MLCO should consider the internal SARs filed by employees along with relevant information about clients of the fund, and if he considers the activity to be suspicious, he should file an external SAR with the government. Should governmental authorities inquire further into the report, the MLCO must respond to requests for information from these officials. They are also responsible for obtaining and checking government-issued compilations of individuals and organizations involved in money laundering or terrorist activity, or those persons or organizations who reside in, or are organized in, non-co-operative territories and jurisdictions. Additionally, they must establish and maintain programs for employee training and awareness of money laundering activity, and make periodic reports to the fund's manager. Finally, the MLCO is responsible for the retention of records relating to identity verification and client transactions. He must also retain records relating to actions taken pursuant to both internal and external SARs and records relating to the nature of, and participants in, the employee training programs. These records generally should be retained for a minimum of five years.

Importantly, although the MLCO is to be appointed by the manager of the fund, his or her discretion cannot be subject to approval of another. Furthermore, any external SAR made cannot be subject to the consent or approval of any other person, especially the investor or prospective investor who is the subject of the report. The SAR must remain confidential.

The person who ultimately serves as the MLCO should be an officer of the fund, have a certain amount of seniority in the hierarchy of authority, and have sufficient time and resources to carry out the duties of the office. However, in larger, more complex financial institutions, the MLCO should not have other responsibilities in the functional areas where money-laundering activity may occur. The MLCO should be familiar with the requirements of the BSA, as well as being familiar with money laundering risks, and should have the authority to develop and enforce appropriate anti-money laundering policies and procedures.

Employee education and training

Another component of a manager's anti-money laundering program is continuing employee education and training. This part should include both general awareness and specific training programs. Employees should be made aware of their responsibilities under the anti-money laundering laws and regulations, the effect of their failure to obey them, and the role of the MLCO. Additionally, they should be generally aware of KYC and SAR requirements.

On the commencement of employment with the manager, employees should participate in educational programs geared toward general awareness and understanding of money laundering issues and concerns, as well as job-specific guidance regarding particular employees' roles and functions. These should be followed up by periodic refresher courses throughout their relationship with the fund. The manager's anti-money laundering policies and procedures should be made available to employees at these training programs.

The two most important functions employees play in implementing the anti-money laundering program of the fund are enforcing the KYC provisions (discussed below), and implementing the SAR aspect of the anti-money laundering regime. It is the employees of the manager who interact with the investors and engage in transactions, and they must, therefore, be aware of the firm's KYC policies. Also, when an investor is suspicious, or when a customer who it was previously thought did not present a money laundering risk is engaged in suspicious behavior, it is the employees who must file an SAR.

A SAR may be required to be filed whenever an investor is engaged in a suspicious transaction, or should be voluntarily filed whenever suspicious activities are otherwise detected. SARs are not mandatory for fund managers at the present time, but they are advisable and likely will be mandatory in the future. The SAR is filed with the MLCO, who then determines what actions are appropriate. In order for employees to characterize the activity of investors or potential investors as suspicious, they need to know two things:

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- the financial circumstances and/or business of the investor or any person on whose behalf they are acting; and
- the features of the transactions which the fund has entered into with, or for, that investor.

Knowing these things will enable employees to detect extraordinary behavior that would warrant the filing of an SAR with the MLCO. Therefore, the training program should focus on enabling employees to know how to collect the information from the investor in order to make these determinations, and further, to be able to detect behavior that deviates from ordinary patterns or expected norms. The training should provide specific real world examples of types of suspicious activity and/or transactions, and also instruct them in how to file an SAR should they observe any suspicious activity or transactions. Records of both the training program and the SARs should be retained by the MLCO, as mentioned above.

The contents of the manager's training program, like its anti-money laundering policies and procedures, should be tailored to the unique attributes of the manager's business, size and investor base, as well as to the specific functions of particular employees.

The independent review

The final aspect of the manager's anti-money laundering compliance program is the independent review of the program. There should be a periodic review to determine that the program is functioning as designed, to ensure that the compliance procedures are indeed being complied with and are effective in detecting and preventing money laundering activities. The results of the review should be documented, retained by the MLCO and reported to the fund's management.

The person or persons responsible for the independent review of the program must be relatively independent of the program. The auditor can be an employee of the manager, or an employee of an affiliate of the manager, or even an independent service provider, so long as the person is not otherwise involved in the operation or oversight of the manager's anti-money laundering program. Clearly, the MLCO cannot also be the auditor. The responsible party and the extent of review will again depend on the size and nature of the fund, as well as the investor base. Thus, for most smaller funds, the reviewer would likely be a third-party service provider (such as the fund's independent accountants, legal counsel or a consultant). Larger funds and companies have more flexibility in this regard, and are likely able to use internal employees who have no connection with the execution of the anti-money laundering program of the particular fund in question, other than the independent review function.

KYC provisions

The KYC provisions of the Act require managers to perform certain minimum actions in order to ascertain and verify the identity of potential investors. The aim of the KYC provisions is to enable the hedge fund to form a reasonable belief that it knows the true identity of each of its investors. The first principle of the KYC provisions is that they embody a risk-based approach. Essentially, this means that the more that a potential risk for money laundering is present, the more diligence the manager should conduct on the potential investor, and vice versa. Diligence in this respect means verification that the potential investor is in fact the same person he or she holds himself or herself out to be to the fund. Generally, when there is a routine subscription to the fund, which raises no red flags (to be discussed below), no extraordinary diligence is required beyond simple identity verification and cross-referencing the identity with a government-issued list of known and suspected terrorists and a list of non-co-operative territories and jurisdictions (those which do not have sufficient anti-money laundering laws). A routine subscription contemplates a citizen of the United States, or a co-operative jurisdiction, subscribing to the fund by transferring money through a regulated financial institution in the United States or a co-operative jurisdiction. If any of these factors are not present, or there are red flags present, more in-depth diligence is required to verify the identity of the investor and legitimacy of their money. What further steps are required is a matter for the discretion of the MLCO, to be exercised in accordance with the procedures adopted by the manager.

The risk-based approach, mentioned above, means that managers should examine their own business and investor base in order to make an informed decision about where its vulnerabilities to money laundering exist, as with the anti-money laundering program, above. This, in turn, will enable the manager to determine how much identification and verification of client identity is required. Rather than mandate specific procedures to be followed in all cases, regulators expect managers to develop and implement best practices that are suited to the manager's business. The KYC provisions can be broken down into four basic elements discussed below.

Obtaining verification of the customer's identity and other vital information

The client's identity and vital information includes the full legal or corporate name, their nationality or country of residence or organization, their street address (not simply a PO Box or 'mail drop' address), social security or taxpayer identification number (TIN), date of birth, sources and amounts of income and net worth, the nature of the investor's business and their reason for doing business with the fund. With respect to trusts, they should identify the

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providers of trust funds and those who have power or control over the trust, as well as the nature and purpose of the trust. It will generally be appropriate to require tangible proof of identification.

Documentary evidence of these things includes unexpired passports, driver's licenses, and other forms of government-issued identification containing photographs and dates of birth, certificates of incorporation, trust agreements, or similar organizational documents. Copies of these items should be made and retained with the MLCO's records.

The KYC regulations for hedge funds have yet to be issued, but it is anticipated that they will not be dissimilar to regulations which would apply to mutual funds. The minimum standards of customer identity verification for mutual funds require obtaining information concerning the customer's name, address, TIN, and for individuals, their date of birth. The address information requires both a mailing address and, for individuals, the address of their place of residence, or for non-natural persons, the address of their place of business. Further identification information should be obtained from customers where appropriate. Importantly, the rules do not require a mutual fund to identify 'beneficial owners' of fund shares. It should be noted that the regulations do not ordinarily require mutual funds to verify the identification of existing customers; only when an existing customer opens another account with the mutual fund must the customer's identification be verified in the manner required for a new customer.

Verification of identity

The identity of a potential investor should always be verified unless a pre-existing relationship exists with the manager or any of its officers. As with mutual funds, it is likely to be the case that even if there is a pre-existing relationship between the fund and the customer, identity must be verified if the customer seeks to open a new account. This duty attaches prior to entering into any contractual relationship or accepting funds from the investor. The manager should rely on the diligence procedures of other financial institutions only if there is a routine subscription (described above) and no red flags are present. Although of limited relevance to a hedge fund, it is also advisable that, at this early stage of the relationship, the manager should attempt to develop an understanding of the types and patterns of transactions in which the investor is likely to engage. Comparing this information against later instances of behavior will help the fund to know when an SAR must be filed.

There are essentially two methods for verifying customer identity:

- documentary evidence, such as actual driver's licenses or passports; and
- non-documentary methods, such as obtaining a credit report on a customer.

Much of the verification of the identity of an investor in a routine subscription can be accomplished simply by examining the documentary evidence. However, non-documentary verification should be utilized when:

- an individual is unable to present appropriate documentary evidence;
- the hedge fund is presented with unfamiliar documents to verify identity;
- the hedge fund does not obtain documents to verify identity;
- the hedge fund does not meet face-to-face with the customer; or
- the hedge fund is presented with circumstances that increase the risk that the fund will be unable to verify the customer's true identity through documents.

Many non-documentary methods can be accomplished through public databases. Social security numbers can be verified through the Social Security Administration's website and the social security death index, as well as those of credit reporting agencies. Various websites are available to verify telephone numbers and addresses, both of which should also periodically be contacted in order to verify their validity. The SEC website, as well as other public databases, can help to verify corporate, trust and partnership information. Finally, credit history and criminal background checks of potential investors might also be conducted. Any further diligence to be conducted on a potential investor is a function of the discretion of the MLCO.

Retention of the records used to verify identity

All evidence used to identify and subsequently verify the identity of a potential investor must be retained by the manager. It should be retained by the MLCO along with the other records required to be retained pursuant to the manager's anti-money laundering program. As with those other records, a good practice would be to retain all such records for a period of not less than five years, although a minimum retention period for hedge funds has yet to be established. The minimum retention period for mutual funds is five years, and it is expected to be the same period for hedge funds. These records are necessary in the event an SAR must be filed with respect to an investor.

Examination of lists of known and suspected terrorists

The Treasury Department's Office of Foreign Assets Control (OFAC) has compiled, and periodically updates, lists of known and suspected terrorists and terrorist organizations.

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The diligence involved in investor identification and verification requires consultation with these lists to ensure that the investor neither appears on any of these lists, nor is associated with any entities, terrorists or territories on these lists. If an investor appears on one of these lists, or is associated with a region or entity on these lists, that is an automatic red flag, meaning that further diligence on the investor is required if his or her subscription to the fund is to be accepted. Should the investor's subscription later be accepted, his or her activities will require constant monitoring. Or, more likely, once one of these red flags is raised, it may be prudent to simply not accept the investor's subscription. These are matters of discretion for the MLCO.

Other red flags include a lack of business or investment experience, a lack of an apparent source of wealth, and a discrepancy in the address or any other form of investor information offered. The Proposed Rules describe other red flags relevant to hedge funds, including an investment by a check drawn on, or a wire transfer from, an account of a third party unrelated to an investor. There are numerous other examples of red flags. If an investor with a red flag is not automatically denied subscription to the fund, their further activities will require constant monitoring, especially if they are ultimately accepted as an investor in the fund. Their activities should be gauged against those patterns of behavior and transactions that the manager should identify at the beginning of the relationship, in order to identify any anomalous behavior that may warrant scrutiny. Other aspects of the program will also require either constant or periodic review. For example, it would be desirable for the manager to periodically re-examine fund subscription documents to ensure that they seek information reasonably calculated to enable the manager to know its clients, their activities, their business and their investment patterns. Also, offering memoranda ought to be periodically scrutinized to ensure that they accurately reflect the fund's customer acceptance policies and any other material information relating to the fund's anti-money laundering and KYC programs.

A couple of areas remain unclear with respect to the extent of verification and diligence required by the KYC provisions as applied to hedge funds. These largely stem from the nature of the hedge fund, having a financially-sophisticated investor base, involving relatively large amounts of money, and where the fund-investor relationship is often created through intermediaries. These characteristics suggest both more and less scrutiny than other, more retail-oriented investment scenarios would invite.

First, it is unclear to what extent the manager can rely on the representations of third parties concerning investors' identities. In the 'plain vanilla' case, where the intermediary between the fund and the investor is another financial institution in the US, or in a co-operative jurisdiction with

comparable anti-money laundering laws, the manager can likely rely on the diligence of the intermediary, and simply needs to document its reasons for doing so adequately. At the other extreme is the situation where the intermediary is located or organized in a known money laundering haven, and displays a reluctance to divulge information about the investor. In this situation, at the very minimum, the utmost diligence is required, but the prudent thing to do may be to deny the investor's subscription to the fund. A great deal of uncertainty surrounds the situations between these two extremes, and further guidance will be available in the future when the Treasury and SEC propose rules concerning hedge funds' KYC obligations.

A second area of uncertainty, related to the first, concerns the procedures to be employed when dealing with institutions and other entities. When dealing directly with the potential investor, which is an institution, there is controversy surrounding the question of whether the beneficial owners must be identified. In the more likely case, where the institution dealing directly with the fund is really just an intermediary, as above, there is uncertainty as to how much diligence must be conducted in order to verify the identity of the ultimate beneficial owner of the security being acquired. As a starting point, the status of the intermediary between the fund and the next party must be determined, ie, whether they appear on a list of suspected terrorist organizations, and if not, whether they are organized under the laws of a known money laundering haven. If the intermediary is organized in a reputable jurisdiction other than the United States, though, to what extent can the manager rely on the diligence of such institution? Is having the institution sign an agreement stating that it understands US anti-money laundering law and has complied with it sufficient? How much further must the fund go? What if the intermediary is organized under the laws of a known money laundering haven? All these questions remain to be answered in the future, when the Treasury and SEC issue final rules concerning hedge funds. In the meantime, it would appear to be the prudent course of action for the fund to err on the side of caution, and to scrutinize foreign investors to the extent reasonable and practical under the circumstances.

A separate, but related, question is the extent to which managers may delegate their compliance responsibilities to administrators or other third-party service providers. The Proposed Rules make it clear that if the manager elects to delegate responsibility to a third party, the manager nevertheless remains responsible for the effectiveness of the program and assuring ongoing compliance with the requirements of the Act. Importantly, in the case of offshore administrators and other non-US service providers, the manager is responsible for ensuring that federal examiners will have access to the relevant information and records and the ability to inspect the third party.

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Special problems associated with a fund of funds

Funds of funds, as investors, present special problems for the underlying managers with which such funds invest. At a minimum, the manager of the underlying fund clearly should obtain representations from the manager of the investor fund in the subscription documents that it has adopted an anti-money laundering program. Anything beyond that, however, is uncertain. There ought to be some element of review of the anti-money laundering program of the investor, but it is unclear how much review is required. Is it enough for each fund to state that they understand US anti-money laundering law and are in compliance? How far beyond this does the manager of a fund have to go before accepting a subscription from a fund of funds? Perhaps some kind of familiarity with each fund's anti-money laundering program is called for. But do they need to examine the actual written program itself, or can they rely on the assessment of a third party that the program is sufficient? Emerging industry practice appears to be that absent the presence of red flags, it is sufficient to rely upon appropriate representations made in this regard.

The Proposed Rules merely state that the manager must analyze the money laundering risks posed by the fund using a risk-based evaluation of relevant factors.

Interim steps

Despite the continuing delay by the Treasury in adopting final rules, many hedge fund managers have found it necessary to adopt an effective anti-money laundering program. This action is necessary for a variety of reasons, including: (i) requirements imposed by banks, broker-dealers, prime brokers and other counterparties with whom the fund does business; (ii) requirements imposed by the jurisdiction in which the fund is organized (if outside of the United States); and (iii) informal admonitions to do so by the SEC on the basis that it is an integral element of an effective risk management program.

Conclusion

As a result of the USA PATRIOT Act of 2001, hedge fund managers now have a number of additional duties concerning their customers' identities and the potential for money laundering activities. How far these laws require the manager to go is uncertain as of yet. It is clear that, at a minimum, managers must implement an anti-money laundering program and develop KYC procedures. Beyond that, uncertainty exists, but the future will likely bring developments that will clarify some of these issues. In the meantime, it should be emphasized that these

requirements are not meant to be cost-prohibitive and are open to flexibility. Until more definite guidelines are issued, fund managers need to shape their programs to the particularities of their fund, but need not do so any more than is practical or reasonable. At the same time, doing nothing and ignoring the requirements of the Act could subject the manager to criminal penalties.