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Anti-Money Laundering Programs for Investment Advisers

The Financial Crimes Enforcement Network ("FinCEN") of the U.S. Department of the Treasury ("Treasury") recently proposed a new rule (the "Proposed Rule") requiring certain investment advisers to establish anti-money laundering programs. The Proposed Rule would apply to certain general partners and managers of private investment funds, including buyout funds, venture capital funds, mezzanine funds, distressed funds and funds of funds.

On October 26, 2001, anti-terrorism legislation known as the Uniting and Strengthening America Act by Providing Appropriate Tools Required to Intercept & Obstruct Terrorism (USA Patriot) Act of 2001 (the "Act") was passed into law resulting in significant amendments to the Bank Secrecy Act ("BSA"). The Act is intended to stop the flow of terrorist funds around the world and requires financial institutions to establish anti-money laundering programs. Under the Act, the Secretary of the Treasury (the "Secretary") is authorized to prescribe minimum standards for these anti-money laundering programs. The Secretary delegated this authority to the Director of FinCEN who in turn has prescribed anti-money laundering rules for financial institutions, including the Proposed Rule for certain investment advisers.

I. Which investment advisers are covered by the Proposed Rule?

The Act does not expressly define investment advisers as "financial institutions." However, the Proposed Rule includes certain types of investment advisers as "financial institutions" based on the nature of the activities they engage in, thereby requiring them to establish anti-money laundering programs. Relying on definitions used in the Investment Advisers Act of 1940 and by the U.S. Securities and Exchange Commission ("SEC"), the Proposed Rule requires the following two types of investment advisers to have anti-money laundering programs:

First, investment advisers with discretionary or non-discretionary authority over assets that (a) have a principal office and place of business in the United States, (b) are registered with the SEC, and (c) report to the SEC that they have assets under management; and

Second, investment advisers that (i) have a principal office and place of business in the United States, and (ii) are not registered with the SEC, but have $30 million or more of assets under management and are relying on the registration exemption for advisers with fewer than 15 clients and that do not hold themselves out generally to the public as investment advisers.

To prevent redundancy, the Proposed Rule would exclude those entities that would qualify as unregistered advisers but that are otherwise required to have an anti-money laundering program under the BSA because they are dually registered as a financial institution in another capacity and are examined by a federal functional regulator for compliance with the requirement in that other capacity (such as a commodity trading advisor). Moreover, the Proposed Rule would permit investment advisers covered by the proposal to exclude from their anti-money laundering programs any of their investment funds that are already subject to an anti-money laundering program requirement (which may include "hedge funds" -- or investment vehicles that allow an investor to redeem its interest within two years -- captured by another proposed rule circulated last year).

II. What are the minimum requirements of an anti-money laundering program?

The Proposed Rule would require each investment adviser covered by the proposal to develop and implement its "*own*" anti-money laundering program reasonably designed to prevent the firm from being used to launder money or finance terrorist activities and to achieve and monitor compliance with the requirements of the BSA and FinCEN's implementing regulations. The Proposed Rule requires each program to include four minimum requirements:

1. establish and implement written policies, procedures and internal controls reasonably designed to prevent the investment adviser from being used to launder money or finance terrorist activities;

2. provide for independent testing of compliance by adviser personnel or a qualified outside party;

3. designate one or more persons responsible for implementing and monitoring the operations and internal controls of the anti-money laundering program; and

4. provide for ongoing anti-money laundering program training for appropriate persons.

Notwithstanding these minimum requirements, each investment adviser would be required to tailor its anti-money laundering program to address the risks presented by the nature of its services and clients by using a risk-based evaluation of relevant factors, including the type of entity, its location, and the statutory and regulatory regime of such location.

Importantly, the Proposed Rule allows each investment adviser to implement its program in a manner reasonably practicable in light of the firm's size and resources. While larger firms would be expected to adopt detailed procedures addressing the responsibilities of the individuals or departments involved in carrying out each aspect of the program, smaller firms would be able to adopt procedures consistent with their simpler, centralized organizational structure.

III. Will the Proposed Rule require a regulatory filing?

The Proposed Rule would require unregistered investment advisers covered by the proposal to make an annual filing of a brief notice with FinCEN containing certain identifying information, including contact information for the investment adviser and its anti-money laundering compliance officer, the total number of its clients and the total amount of its assets under management.

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The opportunity to comment on the Proposed Rule ends in early July and the final adoption of the rule (or a variation thereof) is not expected until, at the earliest, the end of the year. An investment adviser would not need to have an anti-money laundering program in place until 90 days after the final rule is published in the Federal Register. Nevertheless, it may be advisable for general partners and managers of private investment funds to begin considering and implementing anti-money laundering programs. Please note that FinCEN is also considering whether investment advisers should be subject to the additional requirements of the BSA, including filing suspicious activity reports with FinCEN.

Please contact Marco V. Masotti at the number below or any other member of our Investment Funds Group for assistance in developing a compliance program and any related materials for your firm. The summary set forth herein is intended to be general in nature. This memorandum is not intended to provide legal advice with respect to any particular situation and no legal or business decision should be based solely on its content.

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