SCHULTE ROTH & ZABEL LLP

#28

919 Third Avenue
New York, NY 10022
(212) 756-2000
fax (212) 593-5955

www.srz.com

Writer's Direct Number
(212) 756-2587

Writer's E-mail Address
betty.santangelo@srz.com

November 25, 2002

VIA ELECTRONIC MAIL

Judith R. Starr, Chief Counsel
Office of Chief Counsel
Financial Crimes Enforcement Network
Department of the Treasury
P.O. Box 39
Vienna, Virginia 22183-1618

Attention: NPRM-Section 352 Unregistered
Investment Company Regulations

Re: Proposed Anti-Money Laundering Program
Rule for Unregistered Investment Companies

Dear Ms. Starr:

On behalf of certain of our private investment fund or "unregistered investment company" clients, including various hedge funds, Schulte Roth & Zabel LLP appreciates the opportunity to comment on the proposed rule issued by the Financial Crimes Enforcement Network of the Department of the Treasury ("Treasury"), that would require unregistered investment companies to establish and implement anti-money laundering compliance programs ("AML programs"), pursuant to section 352 of the USA PATRIOT Act of 2001 (the "PATRIOT Act").

Our private investment fund clients are committed to assisting Treasury in deterring and preventing both money laundering activity and terrorist financing, and they are supportive of the application of the AML program requirements under section 352 of the PATRIOT Act to their operations. Indeed, certain of our clients have already voluntarily begun planning and implementing their own AML programs, as well as adopting additional compliance measures designed to prevent potential illegal activity from being conducted through their funds.

In this letter, we raise a number of issues that we believe may require clarification, as well as to make recommendations, that will, in our view, enhance the

effectiveness of the anti-money laundering measures that may be applied to this particular industry.

Overview of the Proposed Rule

Section 352 of the PATRIOT Act, which amends section 5318(h) of the Bank Secrecy Act ("BSA"), requires all financial institutions, including investment companies, to establish AML programs that are reasonably designed to prevent such institutions from being used to launder money or finance terrorist activities. In the proposed rule, Treasury seeks to apply the AML program provisions articulated for other industry participants under section 352 to certain previously exempted investment companies. Specifically, the proposed rule would apply to unregistered investment companies that are defined as, subject to certain limitations and exceptions: (i) an issuer that, but for the exclusions provided in sections 3(c)(1) and 3(c)(7) of the Investment Company Act of 1940 (the "'40 Act"), would be an investment company under the '40 Act; (ii) a commodity pool; and (iii) a company that invests primarily in real estate and/or interests therein. As Treasury explains in the preamble to the proposed rule, this definition generally includes entities consisting of pools of various asset classes (securities, commodities, and real estate), and covers hedge funds, private equity funds, venture capital funds, commodity pools operated by commodity pool operators ("CPO"), and real estate investment trusts.[1]

Under the proposed rule, an unregistered investment company must devise and implement, within 90 days following publication of a final rule, a written AML program that includes, 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 function to test programs.[2] Each AML program must be approved in writing by the investment company's board of directors or trustees, or if it does not have such a board, by its general partner, sponsor, organizer, operator or other person that has a similar function with respect to the company.[3] The proposed rule also requires that each unregistered investment

---

[1] 67 Fed. Reg. at 60,618. To narrow the definition of an "unregistered investment company" so that it encompasses only those companies that pose a risk of money laundering activities, Treasury proposes three limitations on the definition and four exceptions to the scope of the term. Under the proposed definition, an "unregistered investment company" would include only those companies that: (i) permit an investor to redeem any portion of his or her ownership interest within two years after that interest was purchased; (ii) have total assets of $1,000,000 or more (including received subscriptions to invest) as of the end of the most recently completed calendar quarter; and (iii) are organized under the laws of a State or the United States, sell ownership interests to U.S. persons (as defined in 17 C.F.R. 230.902(k)), or are organized, operated, or sponsored by U.S. persons. 31 C.F.R. § 103.132(a)(6)(i)(B) - (D).

In addition, the proposed rule also would exempt the following entities from the definition of "unregistered investment company": (i) family companies; (ii) employees' security companies; (iii) employee benefit plans (as that term is defined in 17 C.F.R. § 4.5(a)(4)) that are not construed to be pools; and (iv) to prevent duplicative application of the anti-money laundering rules in the BSA to the same financial institution, companies that also are another type of financial institution under the BSA (such as broker-dealers) and that are required to establish AML programs under separate BSA regulations. 31 C.F.R. § 103.132(a)(6)(ii)(A) - (D).

[2] 31 C.F.R. § 103.132(b), (c).

[3] 31 C.F.R. § 103.132(b).

company file a short notice with Treasury identifying itself and providing some basic information about the company.[4]

Specific Comments to the Proposed Rule

While the overall parameters of the AML requirements under the proposed rule appear reasonable, there are a number of implementation provisions in the proposed rule that, in our view, are more difficult to enforce absent additional clarification and/or modification. We highlight these specific provisions below.

1. Definition of Unregistered Investment Company

In the proposed rule, the definition of "unregistered investment company" includes the requirement that the company is "organized under the law of a State or the United States, is organized, operated or sponsored by a U.S. person, or sells ownership interests to a U.S. person."[5]

Initially, we request clarification as to the status of a foreign unregistered investment company whose only nexus to the United States is that it utilizes a prime broker organized in the U.S. for clearing settlement margins, lending and other services typically provided by a prime broker. We are concerned that this type of business might be viewed as being operated or sponsored by a U.S. person. We assume that when the unregistered investment company retains a U.S. prime broker to provide customary prime brokerage services, it does not, for this reason, fall under the definition of an unregistered investment company for purposes of section 352 of the PATRIOT Act. We respectfully ask that Treasury clarify the definition of "unregistered investment company" in the final rule.

2. Compliance Officer

Under the proposed rule, an unregistered investment company must designate an individual or committee with the responsibility for overseeing the AML program.[6] The preamble to the proposed rule states that even if the company delegates to an outside individual or entity responsibility for the implementation and operation of its AML program, the person responsible for supervising the overall program should be an officer, trustee, general partner, organizer, operator or sponsor of the investment company.[7]

We are concerned that this statement implies that a member of upper-management of the appropriate entity (i.e., the general partner or sponsor) must carry out on-going supervision of the unregistered investment company's AML program. We therefore request that Treasury recognize that employees who are not part of upper management, but who are well-positioned to

[4] 31 C.F.R. § 103.132(d). The notice is described in Appendix C of subpart I of 31 C.F.R. part 103.

[5] 31 C.F.R. § 103.32(a)(6)(i)(D).

[6] 31 C.F.R. § 103.132(c)(3); 67 Fed. Reg. at 60,621.

[7] Id.

supervise the company's compliance measures on a day-to-day basis, can fulfill the monitoring and implementation requirements of the rule, with ultimate supervision by management.

3. Training

The preamble to the proposed rule specifies that employees of an unregistered investment company and of any affiliated and third-party service provider must be trained regarding the relevant BSA requirements. Such training can be conducted in-house or through outside training programs. While we recognize that such affiliated and third party service providers should be appropriately trained, as drafted, this requirement suggests that an unregistered investment company would be responsible for training the employees of an affiliated or third-party service provider. Given the structure of unregistered investment companies,[8] it would be impracticable to require an unregistered investment company to train the employees of an affiliate or third-party service provider. We request that the Treasury recognize the ability of an unregistered investment company to rely on the affiliated entity and third-party service provider to adequately train its own employees.

4. Notice Requirement

The proposed rule requires that each unregistered investment company file a short notice identifying itself and providing some very basic information about the company.[9] Unregistered investment companies often employ outside management companies to administer the investment company. We respectfully request that Treasury clarify that a fund administrator or other management company would be permitted to file the required notice on behalf of the unregistered investment company.

Additionally, it is not clear from the language in the proposed rule whether a company's filed notice would be kept confidential or whether it could be made available to the public pursuant to an appropriate Freedom of Information Act ("FOIA") request. Given the confidential nature of the information contained in the notice, we request that the notice be treated as confidential and subject to the protection of applicable confidentiality provisions, including protection under FOIA. In the event that Treasury does not determine the entire notice to be confidential, we request that those portions of the notice that include private information, such as the organizer or sponsor of the investment company, assets under management and number of investors, be deemed confidential.

---

[8] We note that, generally, an unregistered investment company, itself has no employees. Operations (e.g., back office and administrative) for the company are typically performed by the investment manager/sponsor (which is typically under common ownership with the general partner of a domestic private investment fund) or by an independent administrator retained by the investment manager/sponsor on behalf of the fund. In the case of an offshore fund, the entity is typically structured as a corporation (rather than as a limited partnership with a general partner), with a board of directors, but with no officers or employees. The board of directors is most often comprised of non-U.S. individuals affiliated with, or recommended by, an offshore administrator and, occasionally, a representative of the U.S. investment manager.

[9] See 31 C.F.R. § 103.132(d); 67 Fed. Reg. at 60,622.

We also request that the proposed form requesting disclosure of assets and number of investors be revised to permit a response identifying a range (e.g., $10 million to $50 million; 10-50 investors) in order to account for normal fluctuation of such figures.

5. Access to Records of Offshore Third Party Administrators

In the preamble to the proposed rule, Treasury indicated that an unregistered investment company subject to the rule must ensure that federal examiners are able to obtain information and records relating to the AML program and to inspect third parties for purposes of the program.[10] While we appreciate Treasury's desire for law enforcement to have access to a third-party for purposes of investigating the effectiveness of its AML compliance, we anticipate certain obstacles in obtaining from foreign third-parties documentation with respect to individual investors. For example, many foreign jurisdictions have privacy and confidentiality laws that strictly limit the ability of unregistered investment companies to obtain the documentation from foreign third-parties envisioned in the proposed rule.

We therefore recommend that Treasury narrow this provision to require unregistered investment companies to enable federal examiners to obtain information and records relating to the AML program of a third party, where not otherwise limited by the laws of the jurisdiction to which the third party is subject.

6. Reliance on Intermediaries and Third Parties

In the preamble to the proposed rule, we believe that Treasury appropriately recognizes the widespread use of intermediaries in the structure of unregistered investment companies. Such intermediaries are most often institutional investors such as investment banks, broker-dealers or funds of funds, that, either on a collective basis or separately on behalf of an individual investor, invest the assets of their clients in hedge funds or other unregistered investment vehicles.[11] In those situations, the proposed rule requires the unregistered investment company to "analyze the money laundering risks posed by any entity that invests in it, by using a risk-based evaluation of relevant factors regarding the investing entity."[12] This includes "the type of entity, its operator or sponsor, its location, the type of regulation to which that entity or its operator is subject, whether the entity has an anti-money laundering program, and the terms of any such program."[13]

We commend Treasury's endorsement of a risk-based assessment of the money laundering risks posed by investors in an unregistered investment company. Treasury has already acknowledged this risk-based approach in its proposed and interim final rules on enhanced due diligence for private banking and correspondent accounts,[14] its proposed and

[10] Id.

[11] 67 Fed. Reg. at 60,621.

[12] Id.

[13] Id.

[14] Rule 312, 67 Fed. Reg., 37, 736 (May 30, 2002) and 67 Fed. Reg. 48,348 (July 23, 200).

interim final rules for AML programs,[15] the final rule on suspicious transaction reporting for broker-dealers, insurance companies and currency dealers and exchangers,[16] and the proposed rules for identification and verification of customers.[17] With respect to the latter, the risk-based approach more specifically permits customer identification and verification through intermediaries, shared accounts, and contractual outsourcing.[18]

However, in the context of this proposed rule for unregistered investment companies, the suggestion that an unregistered investment company also obtain the "terms" of the entity's AML program, if interpreted broadly, seems ill advised. We believe that such a requirement goes beyond the concept of a risk-based approach and imposes an unnecessary burden on the fund. We therefore request clarification as to the degree of scrutiny that would be required of the "terms" of an intermediary's AML program.

We assume, for example, that institutional investors located in a FATF jurisdiction and subject to AML provisions that are acting as intermediaries (e.g., a fund of funds, or a non-U.S. bank acting on behalf of its own customers), would be considered low-risk based on their existing level of regulation. We therefore suggest that investment companies be permitted to rely on intermediaries in FATF countries to accurately represent the sufficiency of the terms of their AML programs and on-going enforcement of their AML efforts, without the necessity of review and assessment of the terms by the investment manager/sponsor or the administrator. In contrast, investors located in a non-FATF country may warrant more scrutiny with respect to their AML policies and procedures.

In a related area, the proposed rule recognizes the ability of an unregistered investment company to contractually delegate the implementation and operation of certain aspects of its compliance program to other entities through which the company conducts its business, such as fund administrators, investment advisers, CPOs, commodity trading advisors ("CTAs"), broker-dealers (including prime brokers), and futures commission merchants.[19] While apparently approving the ability to delegate AML responsibilities to a third-party, Treasury implies that it has adopted a concept of strict liability in this area.

---

[15] Rule 352, 67 Fed. Reg. 21110 (Apr. 29, 2002) (financial institutions); 67 Fed. Reg. 21114 (Apr. 29, 2002) (money services business); 67 Fed. Reg. 21117 (Apr. 29, 2002) (mutual funds); and 67 Fed. Reg. 21121 (Apr. 29, 2002) (operators of credit card systems); 67 Fed. Reg. 64,067 (Oct. 17, 2002) (proposed rule for insurance companies).

[16] Rule 356, 67 Fed. Reg. 44,048 (July 1, 2002); BSA suspicious activity reporting provision, 67 Fed. Reg. 64,067 (Oct. 17, 2002) (insurance companies); 67 Fed. Reg. 64,075 (Oct. 17, 2002) (currency dealers and exchangers).

[17] Rule 326, 67 Fed. Reg. 48306 (July 23, 2002) (broker-dealers); 67 Fed. Reg. 48289 (July 23, 2002) (banks, savings associations and credit unions); 67 Fed. Reg. 48318 (July 23, 2002) (mutual funds); 67 Fed. Reg. 48328 (July 23, 2002) (futures commission merchants and introducing brokers); 67 Fed. Reg. 48299 (July 23, 2002) (banks that do not have a federal functional regulator).

[18] See, e.g., 67 Fed. Reg. at 48,308 (broker-dealers); 67 Fed. Reg. at 48,331 (futures commission merchants and introducing brokers).

[19] 67 Fed. Reg. at 60,621.

Specifically, the preamble to the proposed rule states that while unregistered investment companies may delegate certain aspects of its anti-money laundering programs to third parties, and thereby the responsibility for such aspects of the program, the unregistered investment company still remains fully responsible for the effectiveness of the program. The preamble emphasizes that it would not be sufficient for an unregistered investment company to simply obtain certification from its delegate that the company has a satisfactory anti-money laundering program. While we recognize that an unregistered investment company must bear ultimate responsibility for the AML responsibilities it outsources, we strongly urge Treasury not to adopt a strict liability approach in such a situation. Once an unregistered investment company ascertains the AML program of the third-party and conducts reasonable monitoring and supervision of those policies and procedures, it should be deemed in compliance with its money laundering duties under section 352 of the PATRIOT Act and the implementing rules.

Given the widespread interaction and inter-reliance between non-U.S. investment companies and U.S. fund administrators and investment managers, this issue is one of significance. For example, a non-U.S. private investment fund managed by a U.S. investment manager often relies on a non-U.S. fund administrator to perform "Know Your Customer" due diligence. If the non-U.S. administrator is located in a FATF country, we would again recommend that the rule recognize the appropriateness of reasonable reliance by the offshore fund and the U.S. investment manager/sponsor on the AML measures undertaken by the administrator in determining compliance with money laundering duties under the PATRIOT Act.

7. Methods for Determining Source of Funds

Another aspect of reliance involves receipt of funds from a non-U.S. investor through that investor's foreign banking or other financial institution. Private investment companies receive funds from all over the world through financial institutions that directly perform the due diligence with respect to the investor. We recommend that, consistent with the risk-based approach, if a private investment company receives funds through a financial institution domiciled in a FATF county, that is also subject to the AML provisions of that country, the private investment company be permitted to rely on the due diligence of the foreign institution for purposes of its own AML program. If the banking or other financial institution transferring funds is not located in a FATF country, then heightened due diligence responsibilities obviously would apply.

8. Offshore Funds Registered Outside the United States

The definition of "unregistered investment company" for purposes of this rule requires clarification as to whether it includes offshore mutual funds that are registered outside the United States.[20] These registered offshore mutual funds do not appear to meet the first definitional prong under the proposed rule, i.e., that they would be an investment company "under the Investment Company Act of 1940, but for the exclusions provided for in section 3(c)(1) and 3(c)(7) of that Act." While we do not believe these entities fall under this rule, we

[20] See footnote 1, supra.

understand that various registered offshore mutual funds have arrived at conflicting interpretations as to whether the proposed rule applies to them.

If, in Treasury's view, such registered entities were deemed to satisfy the first prong of the proposed rule, they would also likely meet the second,[21] third[22] and fourth prongs. Our concern arises in particular with respect to the fourth prong which requires that, to be covered by the proposed rule, an investment company be "organized under the laws of a State or United States, sell ownership interests to U.S. persons . . . or [be] organized operated, or sponsored by U.S. persons."[23]

Indeed, the fourth prong sweeps broadly to capture virtually every fund managed by a U.S. company even if it is registered in its own country and has no U.S. investors. We believe that an offshore mutual fund that is publicly traded and marketed to non-U.S. investors, if subject to adequate AML provisions in the host country or country in which the fund is administered, should not be subject to a duplicative U.S. AML regime. We therefore encourage Treasury to clarify that registered offshore mutual funds do not fall within the purview of the proposed rule.

9. Federal Examiner

The proposed rule does not specify which federal regulators examine private investment funds or unregistered investment companies for compliance with the AML program provisions. Currently, the SEC examines registered investment advisors with respect to compliance with existing securities laws and regulations. Similarly, the Commodity Futures Trading Commission ("CFTC") and the National Futures Association ("NFA") examine CPOs registered with the CFTC, with respect to compliance with existing futures laws and regulations. We recommend that the existing delegation of oversight responsibilities continue with respect to implementation of the AML program rule for unregistered investment companies, with some modification. Thus, we suggest that the final rule for investment advisors who are primarily invested in securities, notwithstanding that they are also registered with the CFTC as CPOs, be subject to examination for compliance by the SEC, while funds that are registered solely as CPOs be subject to examination by the CFTC or NFA.

---

[21] The second prong requires that the investment company permit "an owner to redeem his or her ownership interest within two years of the purchase of that interest." 31 C.F.R. § 103.132(a)(6)(i)(B); 67 Fed. Reg. at 60,623.

[22] The third prong requires that the investment company have "total assets (including received subscriptions to invest) as of the end of the most recently complete calendar quarter the value of which is $1,000,000 or more." 31 C.F.R. § 103.132(a)(6)(i)(C); 67 Fed. Reg. at 60,623.

[23] See footnote 5, supra.

We thank you for the opportunity to comment on the proposed rule, and we hope that the various issues and concerns raised in this letter will be carefully considered by Treasury in formulating an appropriate, yet practicable, final rule. Should you desire to discuss any of the above comments in greater detail, please do not hesitate to contact Steven Fredman at (212) 756-2567 or Betty Santangelo at (212) 756-2587.

Respectfully submitted,

Steven J. Fredman

Betty Santangelo
Schulte Roth & Zabel LLP
919 Third Avenue
New York, New York 10022

cc: Via Electronic Mail

Paul Roye,
Director of the SEC's Division of Investment Management
Cynthia Fornelli,
Deputy Director of the SEC's Division of Investment Management
Patrick J. McCarty,
General Counsel, CFTC