INVESTMENT ADVISER ANTI-MONEY LAUNDERING

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"Money laundering" is a scheme designed to conceal or disguise the source of money obtained illegally. Money laundering starts when a criminal obtains cash from an illicit activity such as drug trafficking or fraud. The cash is deposited into a financial account or converted to a monetary instrument. In an effort to obscure the origin of the cash, the criminal then moves the financial asset from an account at one financial institution to an account at another financial institution. The criminal may switch accounts several more times before finally using the laundered funds to engage in legitimate activities.

USA PATRIOT Act

Congress enacted the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 ("USA PATRIOT Act") on October 26, 2001 in response to the terrorist events that occurred on September 11, 2001. The USA PATRIOT ACT created new anti-money laundering requirements for financial institutions, including, for the first time, hedge funds and investment companies. Banks and broker-dealers were already subject to existing anti-money laundering laws, including the Money Laundering Control Act of 1986 and the Bank Secrecy Act of 1970. The USA PATRIOT Act amended these laws to add new requirements and to extend existing provisions to other types of financial institutions. Financial institutions that fail to comply with these requirements face exposure to severe civil and criminal penalties.

Financial Institutions

Anti-money laundering laws apply only to firms that meet the definition of a "financial institution, which includes banks, broker-dealers, mutual funds, and any entity required to register as a commodity pool operator or commodity trading adviser. See § 31 U.S.C. §5312(a)(2). It is unclear whether private investment companies (including hedge funds) meet the definition of a financial institution. It is expected that the U.S. Department of Treasury, in collaboration with the SEC, will address this issue in the latter part of 2002.

Certain financial institutions, including broker-dealers, and most kinds of banks, meet the definition of "covered financial institutions." See § 31 U.S.C. Section 5318(j)(1). These institutions are subject to additional requirements, including anti-money laundering rules governing correspondent accounts with foreign banks and requiring the filing of currency transaction reports and suspicious activity reports with various government agencies.

Investment advisers do not meet the definition of a "financial institution." An investment adviser that has private investment company and mutual fund clients, however, must

implement or arrange for the implementation of anti-money laundering procedures for the investment company clients.

Banks and broker-dealers registered as investment advisers are required to comply with anti-money laundering laws. An investment adviser that is "willfully blind" to money laundering that is occurring within accounts that it manages may be subject to criminal liability. See 18 U.S.C. §§ 1956 and 1957.

USA PATRIOT Act Requirements

§ 352 of the USA PATRIOT Act requires a financial institution (as defined in § 31 U.S.C. Section 5318(j)(1)) to implement an anti-money laundering program that has, at a minimum, the following four requirements:

1. Policies, procedures and controls designed to detect and prevent money laundering;
2. A compliance officer whose role is to oversee the program;
3. Training for employees on how to detect and prevent money laundering; and
4. Periodic audits of the anti-money laundering program.

1. Anti-Money Laundering Procedures

An investment adviser should implement procedures that can reasonably be expected to promote the detection and reporting of suspicious activity. Investment advisers vary in size, type of client, organizational structure and investment strategies. Some investment advisers may have primarily natural person clients, whereas other advisers primarily have institutional clients. Many advisers have direct contact with their clients; other advisers obtain clients through intermediaries such as banks, broker-dealers and other investment advisers. In the latter case, the adviser may have little face-to-face contact with its clients. The precise make-up of an investment adviser's anti-money laundering procedures depends on the type of firm it is, the scope of its client base, the nature of its business and the compliance resources it has available.

Regulators are looking for three basic elements in any investment adviser's anti-money laundering program: (a) client identification; (b) suspicious activity monitoring; and (c) taking action when suspicious activity or money laundering is detected.

a. Client Identification

Anti-money laundering regulators expect the investment adviser's anti-money laundering program to have procedures designed to identify prospective clients at the time an account is open, with an emphasis on screening for prohibited clients and identifies clients with high risk characteristics.

The identification procedures should not permit a new client account to be opened unless the firm has identified the prospective client and other beneficial owners of the account.

An account should be opened for a corporate, trust or other legal entity account only if it can be established that the entity has been duly organized and the adviser has information about the identity of the persons who control the entity. If the firm manages assets from clients obtained through an intermediary, the firm should review the due diligence performed by the intermediary to make sure that the intermediary has followed comparable procedures to identify the prospective client. Furthermore, the investment adviser must verify that the prospective client does not appear on any of the lists of known or suspected terrorists that is published by various governmental agencies.

When analyzing whether to open an account, the investment adviser should collect and analyze the following types of information about the prospective client: (1) purpose for opening the account; (2) anticipated account activity; (3) source of wealth (i.e., activity that has generated net worth); (4) estimated net worth; (5) source of funds and means of transfer of funds to open the account; and (6) references or other information to corroborate the reputation of the potential client. After analyzing this information, the investment adviser should not accept as a client a person:

- Who cannot sufficiently identify;
- Who presents high risks in terms of the potential to commit money laundering, unless such person clears enhanced due diligence procedures;
- That appears on the Specially Designated Nationals and Blocked Persons List, which is maintained by the Office of Foreign Assets Control ("OFAC");
- That appears on the Control List, which the SEC will disseminate to financial institutions in the near future; or
- That is from a country that has been deemed by the U.S. Financial Action Task Force on Money Laundering as being non-cooperative with international anti-money laundering efforts.

Monitoring for Suspicious Activities

The investment adviser should monitor for types and patterns of suspicious activities that may suggest money laundering. A suspicious activity is a transaction that an employee knows or suspects to:

- involve proceeds from an illegal activity;
- evade currency transaction reporting requirements;
- vary significantly from the client's normal investment activities; or
- have no business or apparent lawful purpose and the Adviser knows of no reasonable explanation for the transaction after examining the available facts, including the background and possible purpose of the transaction.

Examples of suspicious activities, which should be included in the firm's anti-money laundering procedures, include:

- frequent wires in an out of a client's account where such activity is abnormal for the account;
- a request to wire money to an OFAC blocked country;
- several money orders received within a short span of time on a recently opened account;
- multiple accounts under a single name or multiple names, with a large number of inter-account transfers;
- high level of account activity with low level of securities transactions;
- large wire transfers immediately followed by withdrawal by check or debit card;
- client appears to act as an agent for an undisclosed principal;
- cash transactions involving a large dollar amount;
- transactions that lack business sense or that are inconsistent with the client's investment strategy;
- client exhibits unusual concern for secrecy, particularly with respect to his or her identity, type of business, and assets;
- client's account indicates large or frequent wire transfers to unrelated third parties;
- client or beneficiary has a questionable background, including prior criminal charges or convictions; and
- client has difficulty explaining the nature of his or her business.

High risk client accounts should be monitored more frequently. High risk clients include persons:

- who are resident in or have funds sourced from "Non-Cooperative Jurisdictions;" i.e., countries identified by the U.S. Department of Treasury to have inadequate anti-money laundering regulations or that represent high risk for crime or corruption;
- engage in any activity that is deemed to be a "primary money laundering concern" (the U.S. Department of Treasury maintains a list of foreign jurisdictions, foreign financial institutions, classes of transactions within or involving a foreign jurisdiction, and types of accounts that pose a primary money laundering concern);
- whose source of wealth emanates from activities known to be susceptible to money laundering; and

- who have positions of public trust in developing countries such as government officials, senior officers of government corporations, and important political party officials.

c. Reporting Suspicious Activities and Taking Other Appropriate Action

An integral part of an anti-money laundering program are procedures on how the adviser or its employees should react to suspicious activities or when they detect money laundering. The adviser's procedures should expressly prohibit any employees from engaging in any transaction or assisting a client with any transaction that involves money laundering.

A firm's anti-money laundering procedures should require any employee who detects suspicious activity to promptly report the suspicious activity to his immediate supervisor and the firm's compliance officer. If necessary, the compliance officer should discuss the suspicious activity report with the firm's senior management and, if serious, should report the suspicious activity to law enforcement (local, state, federal), place a stop transfer on the client account, or take some other appropriate action.

2. Compliance Officer

The USA Patriot Act requires a financial institution to designate an employee to be an anti-money laundering compliance officer. This officer should have sufficient responsibility, authority and support to implement and operate the firm's anti-money laundering program. Specific tasks commonly performed by an anti-money laundering compliance officer include monitoring the firm's compliance with its anti-money laundering procedures, conducting employee training sessions, and reviewing reports from employees about suspicious activity.

3. Training

Anti-money laundering laws require the adviser to provide anti-money laundering training of senior management and employees who have contact with clients or responsibilities over client accounts. A key component of such training is teaching an employee how to recognize suspicious activities. Training sessions for existing employees should be held periodically to remind them about their responsibilities under the adviser's anti-money laundering procedures and to inform them of any changes to the procedures, as well as major changes to anti-money laundering laws and regulations. The training program should be updated when necessary to reflect new types of clients or new types of investment products made available through the adviser.

4. Audits

An anti-money laundering program must include the periodic audit of the program by an independent auditor. Each such audit will review the adequacy of the anti-money laundering compliance system, records maintained, and forms filed with regulators.

Such audits should occur at least annually. The auditor may be from the firm or outside the firm. The anti-money laundering compliance officer should not participate in any such audit.

Third Parties

Investment advisers typically have relationships with third parties that introduce clients to the adviser or that process client investments and documentation. An investment adviser may provide investment advice to clients of a broker-dealer in connection with a wrap program, serve as a sub-adviser to accounts primarily managed by another adviser, or enter into other relationships with third parties that result in the adviser having little contact with its advisory clients. Under these arrangements, the third party often has direct contact and maintains the primary relationship with the client. The investment adviser has no choice but to rely on the third party to identify the client and monitor for suspicious activities.

Before an investment adviser relies on a third party's money laundering procedures, the adviser must assess whether such procedures are acceptable. The investment adviser should consider reviewing the third party's money laundering procedures, investigating its reputation, and, if the third party is located offshore, reviewing the money laundering laws of the country where the third party is located. The adviser may also want to consider contractually requiring the third party to (1) represent that it will comply with anti-money laundering laws and the third party's anti-money laundering procedures, (2) provide copies of documents used to verify the identity of the clients; and (3) permit the adviser or an outside auditor to inspect its money laundering program. It is important that the investment adviser and third party carefully allocate their anti-money laundering responsibilities and establish lines of communication so that they may share information about suspicious client activities.

Additional Procedures

Banks and broker-dealers must have procedures (not found herein) that cover activities related to private banking accounts and correspondent accounts. For example, broker-dealers are subject to the National Association of Securities Dealer's Rule 3011, which requires a broker-dealer to implement a money laundering program.

SAR Reports

Banks and in the near future broker-dealers must file a Suspicious Activity Report (SAR) related to a transaction (separately or in the aggregate) involving funds or assets of $5000 or more with the U.S. Department of Treasury's Financial Crimes Enforcement Network. An SAR must be filed in one or more of the following situations:

- the financial institution detects any known or suspected federal criminal violation involving the client; or

- the financial institution knows, suspects or has reasons to suspect that the transaction (i) involves proceeds from an illegal activity; (ii) is designed to evade currency transaction reporting requirements; or (iii) has no business or apparent lawful purpose and the financial institution knows of no reasonable explanation for the transaction after examining the available facts, including the background and possible purpose of the transaction.

Currently, investment advisers and advisers to public and private investment companies are not subject to the SAR Report filing requirements. However, they may file such reports on a voluntary basis. Financial institutions that file SARs may not disclose to the suspect or any third party the fact that it has filed a SAR. Filers of SARs are protected from liability arising from a lawsuit or other civil action in connection with the filing of an SAR.

Currency Transaction Reports

U.S. Department of Treasury regulations require financial institutions to report currency transactions over $10,000 to the U.S. Department of Treasury on a Currency Transaction Report or the Internal Revenue Service on Form 8300.

Banks and broker-dealers must have procedures (not found herein) that cover activities related to private banking accounts and correspondent accounts.

Wire Transfers

A bank or broker-dealer must maintain incoming and outgoing wire transfer logs. The purpose of these logs is to identify possible patterns of activity and transfers in and out of the United States that might suggest money laundering.

Offshore Funds and Clients

Investment companies located offshore and investment advisers that manage accounts of foreign clients may be subject to anti-money laundering laws of other nations. For example, most of the jurisdictions where offshore funds commonly organize have anti-money laundering laws, some of which are more stringent than the USA PATRIOT Act. The laws of the appropriate jurisdiction should be consulted prior to operating a private investment company or opening an account in a foreign country.

Records

An investment adviser should maintain certain records related to its anti-money laundering program. These include: copies of documents used to verify a client's identity; internal suspicious activity reports prepared by the adviser; copies of any report filed with a federal agency; and employee attendance at anti-money laundering training sessions.