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#12

November 22, 2002

VIA E-MAIL

Financial Crimes Enforcement Network
Department of the Treasury
P.O. Box
Vienna, VA 22183-1618
Attention: NPRM – Section 352 Unregistered Investment Company Regulations

Re: Comments to the Anti-Money Laundering Program for Unregistered Investment Companies

Ladies and Gentlemen:

Tannenbaum Helpern Syracuse & Hirschtritt LLP appreciates the opportunity to comment on the proposed rules (the "Proposed Rules")[1] issued by the Financial Crimes Enforcement Network ("FinCEN") of the Department of the Treasury (the "Treasury Department") to implement Section 352 of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (the "USA PATRIOT Act"[2]) with respect to hedge funds, commodity pools, companies that invest primarily in real estate and similar interests therein, private equity funds, and venture capital funds that fall under the category of "unregistered investment company."[3] Section 352 would require unregistered investment companies to (i) adopt a written anti-money laundering program; (ii) conduct audits on a regular basis to test the anti-money laundering program; (iii) appoint a compliance officer; and (iv) provide ongoing employee training on anti-money laundering.[4]

FinCEN initially deferred the application of Section 352 of the USA PATRIOT Act for certain financial institutions such as those that fall under the category of unregistered investment company because FinCEN recognized the need to further study

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[1] FinCEN; Anti-Money Laundering Program for Unregistered Investment Companies, 67 Fed. Reg. 60617-60625 (September 26, 2002).
[2] Pub. L. 107-56 (2001).
[3] See 31 C.F.R. 103.132(a)(6)(i)(A)-(D). The term "unregistered investment company" would be a sub-category of the term "investment company." See 67 Fed. Reg. at 60618.
[4] 31 C.F.R. 103.132(c)(1)-(4).

the application of the anti-money laundering provisions of the USA PATRIOT Act for a segment of the U.S. financial industry which in general has been unregulated by U.S. federal regulators.[5] We commend FinCEN's decision to defer application of the USA PATRIOT Act until after further study in light of the unique characteristics of unregistered investment companies rather than a wholesale imposition of the Act.

We are concerned with certain proposed provisions in the Proposed Rules. Our letter addresses these concerns and provides suggested solutions and starting points. Furthermore, we respectfully request the Treasury Department and FinCEN to clarify certain terms contained in the Proposed Rules.

Specifically, we address the following: (i) the expansion of U.S. jurisdiction over offshore funds and pools; (ii) the problems obtaining written consent from offshore administrators to permit access and inspection by U.S. regulators; (iii) the due diligence to conduct when an investor is an institution or other entity forms; (iv) the potential costs of compliance on small funds and pools; (v) issues surrounding the appointment of a compliance officer by a small fund or pool; and (vi) questions five and six on the proposed form to file notice with FinCEN.

Tannenbaum Helpern Syracuse & Hirschtritt LLP represents numerous hedge funds and commodity pools. As such, our letter focuses on our concerns on behalf of the hedge fund and commodity pool industry.

I. Expansion of U.S. Jurisdiction over Offshore Funds and Pools

FinCEN proposes to establish jurisdictional limits with respect to compliance with the Proposed Rules so that only offshore-based unregistered investment companies with a U.S. nexus would have to comply with the Proposed Rules. Provided that proposed sections 103.132(a)(6)(i)(A)-(C) are also satisfied, an offshore hedge fund or commodity pool would be required to comply with the Proposed Rules if the fund or pool satisfies a U.S. nexus element test as detailed in proposed section 132(a)(6)(i)(D). For the purposes of the Proposed Rules, there is a U.S. nexus if the hedge fund or commodity pool *inter alia*:

[5] FinCEN; Anti-Money Laundering Program for Financial Institutions, Fed. Reg. 21110-21113 (April 29, 2002). Recently, on October 25, 2002, FinCEN issued an interim final rule to extend the temporary deferral for *inter alia* hedge funds, commodity pool operators, and commodity trading advisors the application of the anti-money laundering program requirements in Section 352 of the USA PATRIOT Act. See FinCEN; Anti-Money Laundering Programs for Financial Institutions, 67 Fed. Reg. 67547-67549 (November 6, 2002). The interim final rule to Section 352 amends 31 C.F.R. 103.170 by removing the October 24, 2002 expiration date that would have terminated the temporary deferral. According to FinCEN and the Treasury Department, it would be inappropriate to require these financial institutions to implement an anti-money laundering program during the pendency of the rulemaking process. See 67 Fed. Reg. at 67548. As such, hedge funds, CPOs, and CTAs are exempt from establishing an anti-money laundering program pursuant to Section 352 until final rules are issued which will be within the next six months. See "Treasury Department Issues USA PATRIOT Act Guidance on Section 352," PO-3560 (October 25, 2002).

- sells an ownership interests to a U.S. person,[6] or
- is organized, operated, or sponsored by a U.S. person.[7]

The proposed statutory language suggests that if an offshore fund or pool is organized, operated, or sponsored by a U.S. person, then the offshore fund or pool would be subject to the Proposed Rules. Presumably offshore funds and pools that have a U.S.-based investment manager would be subject to the Proposed Rules provided the other elements to be an unregistered investment company are satisfied. If FinCEN's intended effect is to have offshore funds and pools managed by U.S.-based managers comply with the Proposed Rules, then we support this intention because it puts the application of the USA PATRIOT Act on equal footing with compliance with the OFAC Regulations with respect to offshore funds managed by U.S.-based managers.[8]

A. "Sells an Ownership Interest to a U.S. Person" – Potential Chilling Effect

However, we are concerned with how over-reaching the U.S. government's jurisdiction would be as a result of the proposal that selling an interest to a U.S. person is

[6] For the purposes of the Proposed Rules, the term "U.S. person" has the same meaning as defined in 17 C.F.R. 230.902(k). 17 C.F.R. 230.902(k) defines "U.S. person" to mean (i) any natural person resident in the Unites States; (ii) any partnership or corporation organized or incorporated under the laws of the United States; (iii) any estate of which any executor or administrator is a U.S. person; (iv) any trust of which any trustee is a U.S. person; (v) any agency or branch of a foreign entity located in the United States; (vi) any non-discretionary account or similar account (other than an estate or trust) held by a dealer or other fiduciary organized, incorporate, or (if an individual) resident in the Unites States; and (vii) any partnership or corporation if (A) organized or incorporated under the laws of any foreign jurisdiction; and (B) formed by a U.S. person principally for the purpose of investing in securities not register under the Securities Act of 1933, unless it is organized or incorporated, and owned, by accredited investors (as defined in Section 230.501(a)) who are not natural persons, estates, or trusts.

[7] See 31 C.F.R. 103.132(a)(6)(i)(D).

[8] In July 2002, OFAC issued a release for the securities industry reminding U.S. financial institutions of their obligations under the OFAC Regulations. See Foreign Assets Control Regulations for the Securities Industry (July 3, 2002). In this release, *OFAC specifically addressed hedge funds, particularly offshore hedge funds*, and stated that:

> "**All investments and transactions in the United States or *involving U.S. persons anywhere in the world* fall under U.S. jurisdiction and need to comply with OFAC regulations**. Because of their loosely regulated nature and the ability to handle transactions through offshore locations, US-managed hedge funds and other alternative investment vehicles may be attractive investments for sanctioned targets. . . . All investments instruments should be scrutinized to assure that they do not represent obligations of, or ownership interest in, entities owned or controlled by sanctions targets.
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> U.S. companies and their offshore offices are responsible for maintaining identifying information concerning all clients, investors, and beneficiaries as well as for knowing the source of investment funds. It is recommended that identities be checked against OFAC's SDN list and reported if they appear to be authentic matches."

See Foreign Assets Control Regulations for the Securities Industry, at 2 (emphasis added). Accordingly, offshore funds or pools that are managed by U.S. persons must also comply with the OFAC regulations.

enough to trigger compliance with Section 352 of the USA PATRIOT Act (provided that the lock-up and total assets under management elements are also satisfied).[9] Under the Proposed Rules, a non-U.S. offshore fund or pool managed by non-U.S. persons that sells shares to a U.S. person, e.g. a U.S. tax-exempt entity such as a pension plan, would be required to adopt an anti-money laundering program pursuant to Section 352 of the USA PATRIOT Act. As such, non-U.S. investment vehicles that have no other link with the United States nevertheless would be required to adopt and comply with U.S. law. Such a trigger may be perceived by the offshore financial community as being a tenuous application of U.S. law. Rather than bear the burden and costs of complying with U.S. anti-money laundering laws, offshore funds and pools may decide that the obligations and costs triggered by selling an interest to U.S. persons outweigh the benefits. This could result in a chilling effect of some non-U.S. investment vehicles not allowing investments by U.S. persons (individuals, pension plans, investment vehicles, financial institutions). Therefore, we respectfully request FinCEN to consider eliminating this element as one of the criteria to trigger compliance with Section 352.

B. The Phrase "Organized, Operated or Sponsored by a U.S. Person" Needs Clarification and Limitations

Although we support the application of the Proposed Rules to offshore funds and pools on the basis that such a fund or pool is "organized, operated, or sponsored by a U.S. person," this phrase needs further clarification and limitations. Is FinCEN referring only to U.S.-based investment managers or is this phrase to be more broadly construed? Could a U.S.-based sub-adviser that is an independent contractor trigger the application of the Proposed Rules to an offshore fund? Also, what party is considered the "sponsor" of a fund or pool?

Furthermore, could a U.S. person serving as a director of an offshore fund or pool trigger the application of the Proposed Rules to an offshore fund or pool? Specifically, presuming all other elements listed in proposed sections 103.132(a)(6)(i)(A)-(C) are satisfied, would an offshore fund or pool be deemed to be an unregistered investment company if its sole U.S. nexus is that a U.S. person serves as a director on its board of directors. FinCEN should be cognizant that there are offshore funds and pools managed by a non-U.S. investment manager which sell shares only to non-U.S. persons but have one or two directors who are U.S. persons. Although these offshore funds or pools have a board of directors, day-to-day management of the fund or pool is delegated to an investment manager. As such, directors of an offshore fund or pool may not be involved in the daily operations of the fund or pool. Accordingly, in instances when a U.S. person serves as a director to an offshore fund or pool managed by a non-U.S. investment manager, the U.S. person exercises minimal control over the fund or pool. It can hardly be said that such a fund or pool is availing itself to benefits and protections of the U.S. market to justify the application of U.S. law over an offshore fund or pool that has such minimal contacts with the U.S. market.

[9] See 31 C.F.R. 103.132(a)(6)(i)(D).

Additionally, offshore funds or pools managed by non-U.S. investment managers are regulated by the home jurisdiction's regulatory authority of the fund or pool and of the investment manager, respectively. Generally, these foreign regulatory bodies have adopted anti-money laundering legislation and already require funds and pools to comply with local anti-money laundering regulation. For example, a Cayman Islands fund managed by an U.K. investment manager is regulated by the Cayman Island Monetary Authority and the Financial Services Authority (the "FSA"), respectively. Moreover, such a fund or pool must comply with both the anti-money laundering laws of the Cayman Islands[10] and the UK,[11] respectively. It seems superfluous to require this offshore fund to comply with the USA PATRIOT Act as well when its sole connection with the U.S. is that a director on the board is a U.S. person.

We respectfully urge FinCEN to clarify the phrase "organized, operated, or sponsored by a U.S. person" more precisely and to give specific examples of what is considered to be a U.S. person organizing, operating, or sponsoring a fund or pool as guidance in light of the potentially expansive nature of this phrase.

Also, we respectfully request FinCEN to consider carving out U.S. persons who serve as directors of offshore funds and pools as a basis to trigger the U.S. nexus element pursuant to 31 C.F.R. 103.132(a)(6)(i)(D) when such an offshore fund or pool is managed by a non-U.S. investment manager. Otherwise, the likely impact is that the offshore financial community would perceive the application of the USA PATRIOT Act on offshore funds or pools that are already regulated by its home jurisdiction as an over-extension of U.S. authority and regulatory overkill.

II. Offshore Administrators

It is permissible to delegate *by contract* the implementation and operation of an unregistered investment company's anti-money laundering program to a third-party.[12] If compliance with an anti-money laundering is delegated, according to the commentary, an unregistered investment company would have to undertake the following:

> Obtain **written consent** from the third-party to
>
> (i) Ensure that federal examiners are able to obtain information and records relating to the anti-money laundering program from the third-party; and

[10] A Cayman Islands fund is subject to the following Cayman Islands anti-money laundering legislation and regulations: The Proceeds of Criminal Conduct Law (2000 Revision) and The Money Laundering Regulations, 2000 and the following amending regulations: The Money Laundering (Amendment) Regulation, 2001, The Money Laundering (Amendment) (Client Identification) Regulations, 2001, and the Money Laundering (Amendment) (Electronic Payments) Regulations, 2001.

[11] A U.K. investment manager is subject to the following U.K. anti-money laundering legislation and regulations: the Money Laundering Regulations 1993 and the FSA's Money Laundering Rules.

[12] See 67 Fed. Reg. at 60621.

(ii) Ensure that federal examiners are able to inspect the third-party for purposes of ascertaining compliance with the anti-money laundering program.[13]

Third-party service providers referred to as "administrators" often handle the administrative tasks for hedge funds and commodity pools, particularly funds and pools that are located offshore. In general, most of these administrator are headquartered outside the United States.

We are concerned that these offshore administrators which handle the administrative aspects of the vast majority of funds and pools may balk at agreeing to conduct anti-money laundering compliance pursuant to the USA PATRIOT Act on behalf of their U.S.-based or U.S.-managed funds and pools that fall under the category of unregistered investment company because of two potential problems: first, permitting access and inspection by a U.S. regulator may conflict with an administrator's home jurisdiction's privacy laws; and second, these offshore administrators which are already regulated by their home regulator would be exposing themselves to additional U.S. federal inspection which would be considered redundant and unnecessary from their perspective. We respectfully urge FinCEN to consider our two alternative solutions to these problems: first, FinCEN should compile and publicize a list of offshore jurisdictions which permit U.S. regulators to access an administrator's records and to examine the administrator for anti-money laundering compliance; or alternatively, FinCEN should compile and publicize a list of acceptable jurisdictions where offshore administrators operate which would not require unregistered investment companies to obtain written consent that a U.S. regulator can access information and records and inspect the administrator for compliance on the basis that such administrators are subject to a comprehensive anti-money laundering regime.

A. Conflict with Local Privacy Laws

Since these offshore administrators are subject to their home jurisdiction's laws, there may be legal impediments to allowing U.S. federal examiners access to records and information located offshore. Foreign privacy laws may preclude offshore administrators from allowing U.S. regulators from reviewing and copying records. An offshore administrator may be violating its home jurisdiction's privacy laws if it divulges the identity and records of its clients to third-parties. We urge FinCEN to explore the adverse consequences of the extraterritorial extension of U.S. jurisdiction further before requiring third-party service providers to consent to access and inspection by U.S. regulators.

Furthermore, we strongly urge FinCEN to compile and publicize a list of foreign jurisdictions which would permit a U.S. regulator to access records and information located at an offshore administrator's home office and to inspect an administrator for

[13] See 67 Fed. Reg. at 60621. See e.g. FinCEN; Treasury Department, Securities and Exchange Commission; Customer Identification Programs for Mutual Funds, 67 Fed. Reg. 48318-48328, at 48320-48321 (July 23, 2002).

compliance with its anti-money laundering program. Offshore administrators will likely be resistant to the proposal that a U.S. regulator can go abroad to its home office and subject the administrator to U.S. inspection and hence possible penalties under U.S. law. A unilateral imposition of U.S. law that likely conflicts with a home jurisdiction's privacy laws will be rejected by the offshore financial community. Hence, attempts to obtain written consent for access and inspection as suggested by FinCEN will be rebuffed. What is needed is something akin to a treaty between the United States and a foreign government to convince offshore administrators that access and inspection by a U.S. regulator is permissible. Therefore, we respectfully suggest that FinCEN explore the proposed solution in which the U.S. government in conjunction with the relevant foreign government issues a joint release stating that it is permissible for a U.S. regulator to access and inspect an administrator for the purposes of anti-money laundering compliance and that such access and inspection does not violate the administrator's home privacy laws.

B. Regulatory Redundancy

We wish to point out that FinCEN had taken the position that with respect to due diligence for foreign banks under the proposed rules to implement Section 312, a branch of a foreign bank operating under an offshore branch license would not be subject to additional scrutiny pursuant to proposed section 31 C.F.R. 103.176(b) if the foreign bank has been found or is charted in a jurisdiction where the U.S. Federal Reserve has found it to be subject to comprehensive supervision or regulation on a consolidated basis by the relevant supervisor in that jurisdiction.[14] The rationale is that since such foreign banks are already subject to comprehensive scrutiny and regulation, it would be redundant to subject such a foreign bank to further review.

Accordingly, as a practical alternative solution to obtaining written consent with respect to access and inspection, we respectfully suggest that FinCEN adopt a similar approach for administrators located in particular offshore jurisdictions by having FinCEN compile a list of acceptable jurisdictions that would not require unregistered investment companies having to take the extra steps of obtaining written consent that a U.S. regulator can obtain the information and records and inspect the administrator for anti-money laundering compliance. Certain offshore jurisdictions have already adopted a comprehensive anti-money laundering regime and subject administrators to government oversight.[15] Hence, the U.S. government and unregistered investment companies should

[14] See FinCEN; Due Diligence Anti-Money Laundering Programs for Certain Foreign Accounts, 67 Fed. Reg. 37736-37744, at 37740 (May 30, 2002). As of May 10, 2002, the Federal Reserve has made such a finding with respect to one or more foreign banks chartered in the following jurisdictions: Argentina, Australia, Austria, Belgium, Brazil, Canada, Chile, France, Germany, Greece, Hong Kong Special Administrative Region, Ireland, Israel, Italy, Japan, Korea, the Netherlands, Portugal, Spain, Switzerland, Taiwan, Turkey, and the United Kingdom. See Fed. Reg. at 37740, note 9.

[15] For example, Cayman Islands Licensed Mutual Funds Administrators are regulated by the Cayman Islands Monetary Authority and are subject to The Proceeds of Criminal Conduct Law (2000 Revision) and The Money Laundering Regulations, 2000 and the following amending regulations: The Money Laundering (Amendment) Regulation, 2001, The Money Laundering (Amendment) (Client Identification) Regulations, 2001, and the Money Laundering (Amendment) (Electronic Payments) Regulations, 2001.

be able to take comfort that administrators located in these particular jurisdictions are subject to regulation and scrutiny that comports with the standards under the USA PATRIOT Act. As such, it would be duplicative and therefore unnecessary for a U.S. regulator to inspect these particular regulated offshore administrators as well. Accordingly, FinCEN should consider not requiring the additional undertaking that an unregistered investment company obtain written consent with respect to access and inspection by a U.S. regulator *provided* that an administrator is located in a jurisdiction deemed acceptable by FinCEN.

Moreover, as an added safeguard to our alternative proposal, FinCEN should consider requiring a U.S. regulator to contact the administrator's home regulator and to request that the home regulator itself inspect the administrator's books and records when there is cause.[16] Furthermore, we respectfully suggest that FinCEN consider having U.S. regulators obtain an annual certification from the administrator's home regulator that the home regulator has inspected the administrator's anti-money laundering program and it comports with the standards established by the Financial Action Task Force on Money Laundering ("FATF") as a less intrusive alternative to ensure that a third-party service provider is complying with its anti-money laundering program.

III. Due Diligence With Respect to Institutional Investors and Other Entity Investors

In FinCEN's commentary to the Proposed Rules, FinCEN briefly discusses the due diligence to conduct with respect to institutional investors, particularly fund-of-funds.[17] The extent of due diligence to conduct for institutional investors, especially fund-of-funds, is an issue of primary concern to the hedge fund community. Specifically, the hedge fund community is concerned that a fund or pool would be required to "look-through" entities (e.g. institutional investors, fund-of-funds, partnerships, and trusts) to determine who the beneficial owners are when conducting due diligence as part of its anti-money laundering obligations. To allay this uncertainty, we respectfully request FinCEN to require unregistered investment companies to conduct their due diligence of institutional investors and other entities at the nominee level which would be consistent with FinCEN's previous releases on this issue.[18] Furthermore, as an added safeguard, we strongly urge FinCEN to adopt the position that a representation letter[19] from U.S. and

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Irish licensed administrators are regulated by the Central Bank of Ireland and are subject to the Criminal Justice Act, 1994 and the Guidance Notes for Financial Institutions (Excluding Credit Institutions) Supervised by the Central Bank of Ireland (April 1995).

[16] A court order may be required as well to effectuate the inspection. For example, Section 30 of The Proceeds of Criminal Conduct Law (2000 Revision) provides that a Cayman Islands court may authorize the entry and search of a licensed mutual funds administrator's premises for the purposes of investigating any money laundering offenses specified in The Proceeds of Criminal Conduct Law (2000 Revision).

[17] See Fed. Reg. at 60621.

[18] See *infra* note 22.

[19] In a representation letter, the investing institution would represent to an unregistered investment company that the institution (i) is subject to an anti-money laundering regime; (ii) is regulated by a regulatory body; (iii) has an anti-money laundering program in place; (iv) performs its anti-money laundering obligations in accordance with its anti-money laundering program; and (v) knows who its

non-U.S. institutional investors and other entity investors[20] is an acceptable means to satisfy an unregistered investment company's anti-money laundering obligations in lieu of "looking through" *provided* that the investing institution satisfies certain criteria to determine whether such a letter would be acceptable from an entity investor.

A. Due Diligence at the Nominee Level

In the Proposed Rules, FinCEN notes that the spectrum of investors in an unregistered investment company may include "institutional investors (such as pension funds and corporations), as well as other registered and unregistered investment companies (i.e., "funds of hedge funds")."[21] However, FinCEN did not state whether an entity investor such as a fund-of-funds would be treated as the customer when opening an account with an unregistered investment company. Yet previously, in the proposed rules to implement Section 326 of the USA PATRIOT Act for mutual funds and for Futures Commission Merchants ("FCMs") and Introducing Brokers ("IBs"), respectively, the Treasury Department, FinCEN, the Securities and Exchange Commission, and the Commodity Futures Trading Commission have taken the position that the intermediary entity is the customer with respect to accounts established by intermediaries and not the underlying investors of the intermediaries.[22]

In the proposed rules to implement Section 326 for mutual funds, FinCEN and the SEC commented that a "mutual fund's customer identification program does not have to include verification of individuals' identities whose transactions are conducted through an omnibus account."[23] As such, customer identity verification does not require that a mutual fund obtain any additional information regarding the identities of individual shareholders who open their accounts through an omnibus accountholder.[24] Rather, know your customer due diligence is to be conducted on the omnibus account holder, i.e., the nominee, which is the "customer" for purposes of customer identity verification pursuant to Section 326 of the USA PATRIOT Act.[25]

Similarly, in the proposed rules to implement Section 326 for FCMs and IBs, FinCEN and the CFTC commented that with respect to intermediate accounts, such as

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customers are and none are listed *inter alia* on the OFAC list of Specially Designated Nationals or Blocked Persons. In addition, an unregistered investment company may consider adding to the fifth representation the representation that none of the investing institution's customers are senior foreign political figures from a jurisdiction designated by FATF to be on the list of Non-Cooperative Countries and Territories ("NCCTs") or a jurisdiction considered to be a "primary money laundering concern." See Sections 312(a) and 311(c) of the USA PATRIOT Act.

[20] We suggest that entity investors encompass general partnerships, limited partnerships, limited liability companies, trusts, corporations, banks, and fund-of-funds.

[21] See 67 Fed. Reg. at 60621.

[22] See 67 Fed. Reg. at 48321, note 14; FinCEN; Treasury Department; Commodity Futures Trading Commission; Customer Identification Programs for Futures Commission Merchants and Introducing Brokers, 67 Fed. Reg. 48328-48338 (July 23, 2002).

[23] See 67 Fed. Reg. at 48321.

[24] See 67 Fed. Reg. at 48321.

[25] See 67 Fed. Reg. at 48321.

omnibus accounts and accounts for commodity pools and other collective investment vehicles, it is expected that the focus of each FCM's or IB's due diligence will be on the intermediary itself and not the underlying participants or beneficiaries.[26]

We respectfully urge FinCEN to adopt a similar position for unregistered investment companies by permitting unregistered investment companies to treat institutional investors and other entities as the customer. As such, an unregistered investment company's due diligence obligation would be to focus its due diligence at the nominee level. We believe that adopting such a similar position will settle the uncertainty over how far due diligence must be conducted with respect to institutional investors and other entities. Furthermore, the end result is that the due diligence obligations for unregistered investment companies would be consistent with the due diligence obligations for other U.S. financial institutions that have nominee investor customers.

B. Representation Letter in Lieu of "Looking-Through"

Additionally, we strongly urge FinCEN to explicitly permit unregistered investment companies to receive representation letters in lieu of "looking-through" an entity, particularly non-U.S. entities. Such representation letters would serve as an additional safeguard in the sense that even though an unregistered investment company has conducted due diligence at the intermediary level, an unregistered investment company would be receiving *written assurance* from the intermediary (particularly a non-U.S. intermediary) that it is a regulated entity which has adopted an anti-money laundering program and its underlying investors are not *inter alia* on the OFAC list of Specially Designated Nationals and Blocked Persons. As an added benefit, representation letters would also promote a more efficient allocation of resources with respect to the due diligence to conduct.

It should be noted that other jurisdictions that are significant capital markets centers permit representation letters as an acceptable means to conduct due diligence in lieu of "looking-through" a foreign entity investor. Such representation letters are conditioned on the foreign entity investor being subject to equivalent anti-money laundering laws.[27] We believe that FinCEN should adopt a similar approach as a means to conduct due diligence of entity investors, especially non-U.S. entity investors.

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[26] See 67 Fed. Reg. at 48331.

[27] For example, in the U.K., pursuant to Money Laundering Rule 3.2.5, a U.K. financial institution may satisfy its client identification obligations if the client is a nominee and has

> "given **written assurance** that [it] has obtained and recorded evidence of the identity of the person on whose behalf [it] is acting, and **is subject to regulatory oversight by a relevant overseas regulatory authority and to legislation at least equivalent to that required by the Money Laundering Directive**."

See ML 3.2.5(2) R (emphasis added).

Nevertheless, a representation letter may not be appropriate in certain situations. The federal regulators expect and we agree that U.S. financial institutions must conduct greater scrutiny under certain circumstances such as instances when an entity is located in a high risk jurisdiction.[28] Accordingly, we propose that unregistered investment companies conduct a risk-based analysis based on criteria described below to determine whether a representation letter would be acceptable to satisfy one's anti-money laundering obligations. This criteria would be based on factors listed in the Proposed Rules.[29] As such, institutional nominees and other entity investors should be evaluated according to:

- 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

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In the Cayman Islands, pursuant to Regulations 9(4) and (5) of the Proceeds of Criminal Conduct Law (2000 Revision), a Cayman Islands financial institution may receive "**written assurance**" from the nominee applicant "to the effect that evidence of the identity of any principal on whose behalf the applicant for business may act in relation to that person will have been obtained and recorded" provided that the applicant **is regulated by "an overseas regulatory authority" and "is based or incorporated in, or formed under the law of, a country specified" to have anti-money laundering legislation equivalent to the Cayman Islands**. See Regulations 9(4), (5), and (6); 10(1)(a) and (b); and Schedule 3 of the Proceeds of Criminal Conduct Law (2000 Revision) (emphasis added). Schedule 3 lists countries and territories having equivalent anti-money laundering regulation.

In Bermuda, pursuant to Regulation 4(5) of the Proceeds of Crime (Money Laundering) Regulations 1998, it is reasonable to accept "**written assurance**" from a "foreign regulated institution" "to the effect that evidence of the identity of the principal has been obtained and recorded under procedures maintained by" the foreign regulated institution. See Regulations 4(5) and 2(2)(c) of the Proceeds of Crime (Money Laundering) Regulations 1998 (emphasis added). Regulation 2(2)(c) defines "foreign regulated institution" to mean "a person or **entity subject to regulation in any other jurisdiction which is at least equivalent to the Regulations**." See Regulation 2(2)(c) of the Proceeds of Crime (Money Laundering) Regulations 1998 (emphasis added). Appendix A to the Guidance Notes on the Proceeds of Money Laundering issued by Bermuda's National Anti-Money Laundering Committee lists countries and territories which may be treated as jurisdictions having equivalent anti-money laundering regulations.

[28] In the interim final rule implementing Section 312 of the USA PATRIOT Act, the U.S Treasury emphasized that it expects financial institutions (banks, broker-dealers, FCMs, and IBs) that are currently required to comply with the provisions of Section 312 to "accord priority to conducting due diligence on high-risk" non-U.S. customers. See FinCEN; Anti-Money Laundering Programs; Special Due Diligence Programs for Certain Foreign Accounts, 67 Fed. Reg. 48348-48352, at 48350-48351 (July 23, 2002). See also 67 Fed. Reg. at 48331. In the release to implement Section 326 for FCMs, and IBs, FinCEN and the CFTC stated that FCMs and IBs "should assess the risks associated with different types of intermediaries based upon an evaluation of relevant factors, including the type of intermediary; its location; the statutory and regulatory regime that applies to a foreign jurisdiction; the FCM's or IB's historical experience with the intermediary; references form other financial institutions regarding the intermediary; and whether the intermediary is itself a [Bank Secrecy Act] financial institution required to have an anti-money laundering program." See 67 Fed. Reg. at 48331.

[29] See 67 Fed. Reg. at 60621.

- the terms of its anti-money laundering program.[30]

We suggest the following other factors as part of the risk-based analysis:

- if the entity is regulated – who is the regulator;
- whether the home jurisdiction is a member of an international organization on anti-money laundering such as FATF;
- whether the home jurisdiction is designated by FATF to be a NCCT or is a jurisdiction which is considered to be a "primary money laundering concern" under Section 311 of the USA PATRIOT Act;[31]
- whether the entity is a licensed or registered institution and with whom;
- whether the entity is a public company listed on a stock exchange;[32]
- whether the entity has a pre-existing business relationship with the fund or pool and the duration of the relationship;
- whether the entity remains in "good standing" within its home jurisdiction; and
- the reputation of the entity.

The critical factors underlying the acceptability of a representation letter are the *credibility* and *trustworthiness* of the investing entity because an unregistered investment company would be relying on the entity's representations that the entity had performed its know your customer due diligence. We believe that a risk-based analysis based on the proposed criteria above would assist unregistered investment companies in evaluating the credibility and trustworthiness of an entity. Credibility is determined by assessing: whether an entity is subject to anti-money laundering legislation; whether the home jurisdiction's anti-money laundering legislation comports with international standards; whether the entity is a licensed or registered entity; and whether the entity is subject to government oversight. Trustworthiness is determined by assessing: an entity's reputation; and the business relationship the entity has had with the unregistered investment company. By first vetting an entity investor against the proposed risk-based criteria, an unregistered investment company should be able to make a reasonable determination whether a representation letter from an entity is acceptable because of the entity's credibility and trustworthiness or whether further due diligence is warranted because of the high risk of money laundering or terrorist financing that the entity poses to the unregistered investment company.

Furthermore, in turn, an unregistered investment company would be better able to allocate its resources in combating money laundering and terrorist financing. If an unregistered investment company assesses that an entity is located in a FATF

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[30] See 67 Fed. Reg. at 60621.

[31] See Section 311(c) of the USA PATRIOT Act.

[32] It should be noted that other jurisdictions have listed approved stock exchanges in which a company quoted or listed on such stock exchange would not be subject to "look-through" for the purposes of know your customer due diligence. See e.g. Guidance Notes on the Prevention and Detection of Money Laundering in the Cayman Islands, Section 3.65(d) and Appendix H (June 2002); Guidance Notes for Financial Institutions (Excluding Credit Institutions) Supervised by the Central Bank of Ireland, paragraphs 53 and 54 and Appendix D (April 1995).

jurisdiction, is subject to an anti-money laundering regime, is obligated to perform know your customer due diligence, and is well-known in the industry, then that unregistered investment company should be able to make the reasonable conclusion that the entity poses a low risk and that the entity knows who its customers are. A representation letter from such an entity should be acceptable because of the entity's credibility and trustworthiness. Hence, an unregistered investment company would not have to "look-through" the entity and thus not exhaust its resources to duplicate due diligence that the entity has already performed on its own customers.

On the other hand, if an unregistered investment company vets an entity and concludes that an entity poses a high risk of money laundering or terrorist financing because the entity is located in a NCCT jurisdiction, is not licensed with a government authority, and is not well-known, then the unregistered investment company should expend its resources in performing enhanced due diligence.[33] Due to the absence of credibility and trustworthiness associated with such a high risk entity, written assurance from a high risk entity that it knows who its customers are would be suspect. Under such circumstances, it would not be an unnecessary waste of time and expense to require an unregistered investment company to devote its resources to "looking-through" such a high risk entity in order to determine who the beneficial owners are. In fact, it is expected that a U.S. financial institution commit greater resources to scrutinizing high risk investors.[34]

In light of the benefits associated with representation letters in terms of assurance and the allocation of resources, we strongly urge FinCEN to permit unregistered investment companies to receive representation letters from institutional investors and other entities in lieu of "looking through" an entity *provided* that the entity is credible and trustworthy based on our suggested risk-based analysis.

IV. Potential Costs on Small Funds and Pools[35]

We wish to alert FinCEN about the inherent lack of infrastructure of small hedge funds and commodity pools and the subsequent costs small funds and pools that are unregistered investment companies would likely incur to comply with the Proposed Rules. A majority of small funds and pools are either sole proprietors or are two/three-person shops. It may not be feasible for the fund manager to also "wear the hat" of being the compliance officer on top of his or her other duties. According to FinCEN's

[33] It is expected that FinCEN will publicize the actions to undertake when performing enhanced due diligence when the final rules to implement Section 312 and 326 of the USA PATRIOT Act are released in 2003.

[34] See e.g. FinCEN; Treasury Department; Securities and Exchange Commission; Customer Identification Programs for Broker-Dealers, 67 Fed. Reg. 48306-48318, 48309 (July 23, 2002); 67 Fed. Reg. at 48322; 67 Fed. Reg. at 48333; and 67 Fed. Reg. at 48350-48351.

[35] We use the phrase "small fund and pool" and its permutations to mean those hedge funds, commodity pools, companies that invest primarily in real estate or interests therein, private equity funds, and venture capital funds with assets under management of less than $5 million or those funds or pools employing few personnel. This phrase is not a term in the Proposed Rules and is used by us solely for descriptive purposes.

commentary on the compliance officer, it is permissible for the anti-money laundering program to be conducted by a third-party, e.g. an administrator, but ultimate responsibility for supervision of the program would rest with the compliance officer.[36] Hence, it is possible for a small fund or pool that lacks the infrastructure to conduct an anti-money laundering program to have a third-party conduct due diligence and monitor investor activity on behalf of a small fund or pool as long as the fund's or pool's compliance officer supervises the program. However, since it is likely that small funds or pools that fall under the category of unregistered investment company will have no choice but to delegate implementation of the anti-money laundering program to a third-party, there may be a substantial costs incurred by small funds and pools in terms of fees a third-party service provider may charge in connection with performing a small fund's or pool's anti-money laundering obligations.

Furthermore, even if a small fund or pool were to conduct its anti-money laundering program "in-house," such a small fund or pool may not be able to conduct its audit internally because of the absence of other employees to conduct the audit. As such, a small fund or pool would be forced to hire an independent third-party to conduct the audit and thereby would incur a potentially substantial costs in terms of fees in connection with the audit of the anti-money laundering program.

Given the importance of implementing and conducting an anti-money laundering program, we respectfully suggest that while small funds and pools be required to adopt and conduct or delegate its anti-money laundering obligations, such small funds and pools not be required to conduct an audit until they reach a much higher threshold of assets under management such as $5 million. Presumably, funds or pools of a much higher magnitude can better afford the fees associated with an audit and have a larger pool of employees that can be bifurcated to conduct the anti-money laundering function and the audit function, respectively.

V. Small Funds and Pools – Appointment of a Compliance Officer

The Proposed Rules would require an unregistered investment company to designate a person or persons with the responsibility for overseeing and enforcing the anti-money laundering program.[37] According to FinCEN, the compliance officer should be an unregistered investment company's officer, trustee, general partner, organizer, operator, or sponsor.[38] A potential problem that small hedge funds and commodity pools may face when appointing someone to be the anti-money laundering compliance officer is that the person who handles compliance is not likely to be an officer, trustee, general partner, organizer, operator, or sponsor of a fund or pool but is instead an employee with no executive title. More often than not, it is the administrative assistant at small funds and pools who handle regulatory compliance with the assistance of outside legal

[36] See 67 Fed. Reg. at 60621.
[37] See 31 C.F.R. 103.132(c)(3).
[38] See 67 Fed. Reg. at 60621.

counsel.[39] Accordingly, we respectfully suggest that the list of potential candidates to be appointed the anti-money laundering compliance officer be expanded to include "non-executive employees whose day-to-day duties include compliance."

VI. Certain Questions Asked on the Proposed Form to File with FinCEN

FinCEN proposes that a hedge fund or commodity pool that falls under the category of "unregistered investment company" would be required to file notice with FinCEN.[40] An unregistered investment company would be required to complete and submit "Notice for the Purposes of 31 C.F.R. 103.132(d)" (the "Proposed Form"). The Proposed Form contains a series of specific questions.

Questions five and six in the Proposed Form are unjustifiably intrusive. FinCEN proposes that a hedge fund or a commodity pool divulge the total amount of assets under management and the number of participants, interest holders or security holders in the unregistered investment company.[41] Such questions seem irrelevant in connection with money laundering and terrorist financing.

We respectfully suggest that rather than require unregistered investment companies furnish the exact amount of assets under management, the Proposed Form contain a "check the box" section in which an unregistered investment company checks the box and represents that it has over $1 million under management. We respectfully suggest that FinCEN adopt this approach as a less intrusive means to determine whether an investment vehicle satisfies the criteria to be an unregistered investment company.

We respectfully suggest that FinCEN eliminate the query regarding the number of participants, interest holders or security holders an unregistered investment company since this particular question does not advance anti-money laundering or thwart terrorist activity. No basis has been given why an unregistered investment company would have to divulge the number of investors it has. How does knowing that an unregistered investment company has 3 investors, 98 investors, or 400 investors promote anti-money laundering?

We appreciate the time FinCEN has given to consider our views. If you wish to discuss our comments and suggestions further whether by phone or in person, please feel

[39] Examples of regulatory compliance overseen by non-executive employees include filing Form 13-Fs with the Securities and Exchange Commission on a quarterly basis pursuant to Section 13(f) of the Securities Exchange Act of 1934, as amended and rule 13F-1 thereunder, updating the Form ADV (to the extent applicable), updating National Futures Association information (to the extent applicable), reviewing subscription documents to ascertain whether a potential investor satisfies investor suitability standards (i.e., verifying whether a potential investor is an accredited investor, qualified client, qualified eligible person, and/or qualified purchaser), and investor communications.

[40] See 31 C.F.R. 103.132(d).

[41] See 31 C.F.R. 103.132(d)(3)(v)-(vi).

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Respectfully yours,

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