Dechert

November 25, 2002

Financial Crimes Enforcement Network
P.O. Box 39
Vienna, Virginia 22183-1618

Attention: NPRM - Section 352 Unregistered Investment Company Regulations

Re: Notice of Proposed Rulemaking on Anti-Money Laundering Programs for Unregistered Investment Companies

Ladies and Gentlemen:

Dechert appreciates the opportunity to comment on the Notice of Proposed Rulemaking issued pursuant to Section 352 of the USA PATRIOT Act by the Financial Crimes Enforcement Network of the Department of Treasury, titled "Anti-Money Laundering Programs for Unregistered Investment Companies" ("Proposed Rules").[1]

Dechert is an international law firm with a wide-ranging investment management practice that serves clients worldwide. Our clients include a number of hedge funds and other private or publicly offered investment funds, both domestic and offshore, that would be included under the definition of "unregistered investment companies" under the Proposed Rules. The comments that follow reflect concerns that certain of Dechert's clients have raised, but they represent our own views and are not intended to reflect the views of the clients of the firm.

We fully support FinCEN in its aim of preventing money laundering and the financing of terrorist activities. While we agree with the principles underlying the measures required by the Proposed Rules, we would like to express concern about the breadth of the application of the Proposed Rules. There are serious jurisdictional questions that, as a practical matter, may make compliance unduly burdensome or even impossible for unregistered investment companies formed under non-U.S. law that sell ownership interests to a "U.S. person" (as defined in Regulation S under the Securities Act of 1933, as amended) or are organized, operated, or sponsored by a U.S. person ("Offshore Funds"). The effect of the Proposed Rules on operators of U.S. unregistered funds and non-U.S. participants in the U.S. financial services industry would be substantial, and could have the effect of driving certain investment operations out of the United States (notwithstanding such funds' compliance with strict anti-money laundering regulations imposed by other jurisdictions) or causing them to prohibit investments by U.S. persons.

The Proposed Rules also contain ambiguities with respect to the following provisions that may cause compliance difficulties unless clarified by FinCEN prior to or upon adoption of the final rules: (1) provisions relating to redemption rights, (2) the inspection authority

[1] 67 Fed. Reg. 60617 (Sept. 26, 2002).

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granted to U.S. government agents with respect to anti-money laundering ("AML") programs of Offshore Funds, (3) the "Notice" requirement, (4) the permissibility of an Offshore Fund to delegate the role of compliance officer to a third party when the structure of the Fund would otherwise make compliance with this provision impractical, and (5) a longer phase-in period relating to effectiveness of the regulation. We believe that, as discussed below, clarification and amendment of the Proposed Rules would help to ensure the ability of funds to comply with technical requirements imposed thereunder and would better serve United States commercial interests and the administration of the USA PATRIOT Act.

I. Jurisdictional scope of the Proposed Rules.

As proposed, Section 103.132(a)(6)(i)(D) of the Proposed Rules expands coverage of FinCEN's AML regulations to Offshore Funds. As a legal matter, serious jurisdictional questions are raised by the breadth of this provision. As a practical matter, Offshore Funds may find that foreign governments prohibit the inspections by U.S. government agents that the Proposed Rules contemplate. For these reasons, we request that FinCEN adopt alternative AML requirements for Offshore Funds.

A. FinCEN's jurisdiction.

The jurisdictional reach of the Proposed Rules over Offshore Funds is extraordinarily broad. FinCEN outlines the nexus for jurisdiction vis à vis the benefits Offshore Funds receive from both the financial and legal systems of the United States. Historically, however, the Bank Secrecy Act ("BSA") has not applied to entities located offshore. Treasury noted in a 1987 report, for example, that the BSA's requirements "do not apply to foreign branches of United States financial institutions or to any other type of financial institution physically located outside of the Untied States."[2] Furthermore, FinCEN recently promulgated a rule requiring broker-dealers to file suspicious activity reports under the BSA in which the rule only applies to broker-dealers "*within the United States*" (emphasis added).[3] FinCEN recognized this distinction once more in its Final Rule release for correspondent accounts for foreign shell banks, the same day FinCEN released the Proposed Rules.[4]

In addition, this jurisdictional scope is contrary to the intent of the USA PATRIOT Act. Section 330 of that Act deals specifically with "International Cooperation in Investigations of the Money Laundering, Financial Crimes, and the Finances of Terrorist Groups." This provision in part encourages negotiations between the United States and foreign nations that have financial institutions that do business with U.S. financial institutions. Indeed, 330(b)(2) specifies that the purpose of pursuing such negotiations is partly to "establish a mechanism whereby such records may be made available to United States law enforcement officials and domestic financial institution supervisors, when appropriate."

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2 SECRETARY OF THE TREASURY, MONEY LAUNDERING AND THE BANK SECRECY ACT: THE QUESTION OF FOREIGN BRANCHES OF DOMESTIC FINANCIAL INSTITUTIONS (1987).

3 31 C.F.R. § 103.19(a)(1).

4 67 Fed. Reg. 60562, at 60565 (Sept. 26, 2002).

Section 442 of the Restatement (Third) of Foreign Relations Law, which discusses discovery orders of administrative agencies toward persons outside the United States, provides further guidance: Generally, rules authorizing agencies to require information, production of documents, among others, do not apply to persons outside the United States, even when conduct investigated had an effect in the United States, and therefore "was thus within the United States jurisdiction to prescribe." The Commodity Exchange Act was amended in 1986 to give the Commodity Futures Trading Commission authority to serve a subpoena to a person outside of the US, but only with prior approval of the Commission (7 U.S.C. 15). Based on the language of Section 330 of the USA PATRIOT Act, Congress does not appear to have granted FinCEN similar authority.

B. Foreign jurisdictions might not allow inspections.

Assuming that FinCEN's asserted jurisdiction over Offshore Funds is permissible under U.S. law, this jurisdiction might be inconsistent with foreign law. For example, while an Offshore Fund might be willing to comply with U.S. requirements, the jurisdiction in which the fund is located might not permit the U.S. authorities to inspect. The final rules should be designed to be enforceable and not act as a de facto ban on doing business in jurisdictions where inspections by U.S. authorities require governmental approval.

For example, in Luxembourg with regard to criminal matters such as money laundering, the Treaty on Mutual Legal Assistance in Criminal Matters between the United States of America and the Grand Duchy of Luxembourg dated March 13, 1997, applies.[5] The Treaty clearly lists the procedures that must be followed by the party who wishes to obtain assistance from the other party. Furthermore, pursuant to the Treaty, the central authorities of each country, that is, the Attorney General Department (Parquet Général) for Luxembourg and the Attorney General or a prosecutor for the United States of America, communicate directly with one another.

The purpose of the Treaty, however, is not to allow one country to launch its own investigations in the other country, but for the two countries to cooperate and consequently improve the efficiency of the authorities who are in charge of the application of the laws of the two countries in the investigation, inquiry and pursuit of offenses. Section 330 of the USA PATRIOT Act follows the philosophy of the Treaty, whereas the Proposed Rules ignore such cooperative ideas. Any jurisdiction, including the United States itself, has a legitimate interest in the activities of foreign law enforcement officials within its borders.

C. FinCEN should consider alternative AML requirements for Offshore Funds.

We would like to propose briefly three possible alternatives for AML requirements for Offshore Funds: (1) FinCEN should recognize compliance with AML laws of other jurisdictions; (2) FinCEN should consider recognizing "qualified intermediaries" for the purpose of AML compliance; and (3) FinCEN should tailor the Proposed Rules in coordination with the Financial Action Task Force on money laundering ("FATF").

[5] The Treaty explicitly excludes mutual assistance with regard to direct tax matters unless the matter deals with fiscal fraud.

1. FinCEN should recognize compliance with AML laws of other jurisdictions.

In light of arguments in Sections A and B above, we believe the Proposed Rules should be amended to reflect a spirit of international cooperation. As discussed above, Section 330 of the USA PATRIOT Act encourages cooperation with other jurisdictions. Part of this cooperation, we believe, must involve recognizing that a number of other nations currently have strict, and often long-standing, anti-money laundering regulations in place, which are consistent in principle with the Proposed Rules, but which have technical differences. Offshore Funds that are required to comply with anti-money laundering regulations of Luxembourg, the United Kingdom, the Cayman Islands, Bermuda or Ireland, for example, are already subject to regulations that are comparable (though not identical) to the Proposed Rules.

Compliance with an additional set of requirements would be unduly burdensome from a commercial standpoint without providing a corresponding regulatory benefit. Such cooperation would also better serve international comity.

2. FinCEN should consider recognizing "Qualified Intermediaries" for the purpose of AML compliance.

Many Offshore Funds rely on third party administrators for a variety of fund operations. FinCEN could recognize a class of third party administrators as "Qualified Intermediaries" for the purpose of AML compliance akin to the Qualified Intermediary recognized by the Internal Revenue Service for the purpose of tax withholding for dividends and interest paid to foreign persons.

The AML Qualified Intermediary could enter into a contract with FinCEN, much like the contracts entered into with the Treasury or its delegate, guaranteeing the institution and administration of AML programs for the Offshore Funds it represents. Consequently, the Proposed Rules requirements would apply to the Qualified Intermediary, and not the Offshore Fund. Such an arrangement would relieve many Offshore Funds of the burdens the Proposed Rules would create, especially when many do not have employees, as discussed below. The arrangement would also resolve any concerns about privacy of the Offshore Funds.

3. FinCEN should tailor the Proposed Rules in coordination with FATF.

FinCEN should tailor the Proposed Rules in coordination with FATF, which shortly after September 11, 2001, released special recommendations on terrorist financing. Any coordination would further demonstrate the United States commitment to international cooperation, as well as ensure global uniformity of AML regulations, which would aid in preventing terrorist financing.

II. Request for clarification.

In addition to the aforementioned question of jurisdiction, we request clarification on the following points: (1) the restrictions on redemption rights, (2) the inspection authority, (3) the notice requirement, and (4) the designated responsible AML person requirement for funds with no employees.

A. Restrictions on redemption rights.

The definition of unregistered investment company applies only to a company that provides an investor the right to redeem any portion of the investor's ownership interest within two years of the investment. Thus, any company which has a redemption lock-up period of more than two years or offers no redemption rights at all will not be considered an unregistered investment company for the purposes of the Proposed Rules.

The Proposed Rules, as written, do not specifically address private equity and venture capital funds that provide conditional withdrawal rights to various types of regulated investors, such as pension plans subject to the Employee Retirement Income Security Act of 1974. In many cases, the fund agreements provide that these regulated investors may withdraw their interest if the private fund were to operate in a way that makes it unlawful or disadvantageous from a regulatory perspective for the regulated investor to own an interest in the fund. Since such a conditional withdrawal right could be triggered within the first two years of an investment, we request clarification that such rights are not redemption rights that would subject the funds to the Proposed Rules. Such investment funds are not likely vehicles for money laundering, particularly because the redemption is conditional and limited to certain circumstances.

We also question how collective rights to sell back interests, for example by vote of a class of interests, would be treated under the Proposed Rules. For example, we are concerned that the Proposed Rules may be interpreted too broadly and pick up collateralized debt obligation ("CDO") issuers. Unlike a typical hedge fund, CDO issuers do not provide optional redemption rights to "an investor" within the first two years of a transaction. However, within the first two years of any CDO transaction, the rating agencies require mandatory redemption of a portion of the senior most classes of debt issued by the CDO issuers if certain overcollateralization, interest coverage and other rating parameters are not met due to the performance of the underlying pool of assets or if the collateral manager for the CDO issuer is unable to fully invest the money raised at closing by a specific date. In addition, again in response to rating agency concerns that sufficient cash always be available to cover the rated debt in a CDO transaction, an identified class of investors has the right at any time in the transaction to require a liquidation of the entire transaction, resulting in a redemption of all classes of securities issued by the CDO issuer, if there is a change in tax law and withholding taxes are imposed which reduce the expected cash flow for the transaction by more than a specified threshold. We believe FinCEN intended the Proposed Rules to cover unregistered investment funds which provide the optional right of any investor to require redemption of its investment similar to mutual funds, not redemptions resulting from rating agency requirements for CDO transactions. We request

clarification that the Proposed Rules are aimed at individual redemption rights at the option of the investor.

B. Inspection Authority.

The Proposed Rules note that the inspection authority lies with the Treasury Department or its designee, but contains no amendment to the regulation that addresses inspection authority.[6] For mutual funds, FinCEN modified this enforcement authority regulation to delegate inspection of mutual funds to the Securities and Exchange Commission.[7]

Currently, that regulation contains a default inspection authority, whereby the authority to examine institutions is delegated to the "Commissioner of the Internal Revenue with respect to all financial institutions, except brokers or dealers in securities, not currently examined by Federal bank supervisory agencies for soundness and safety."[8] Thus, unless FinCEN modifies the Proposed Rules, the inspection would lie with the IRS.

We request clarification akin to the AML rule promulgated for mutual funds specifying who would have the inspection authority, preferably an agency familiar with the unregistered investment company industry, such as the Securities and Exchange Commission or the Commodity Futures Trading Commission.

Additionally, we would like to request clarification that the inspecting authority would be able to inspect only those records/information kept on behalf of funds that are subject to the regulations.

C. Notice Requirement.

Our concern over the Notice Requirement is twofold: first, the scope of information requested; and second, the availability of the information requested, once compiled.

1. Scope of information requested.

We question the need to report either the total number of assets under management or the total number of participants. Neither piece of information appears relevant to the pursuit of preventing money laundering or the financing of terrorist activity. Money laundering may occur on both small and large scales.

FinCEN requires the notice so that it can enforce the Proposed Rules, once adopted. The other information provided will satisfy FinCEN's ability to enforce its AML regime for unregistered investment companies. Therefore, we request both those items be deleted from the notice requirement.

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6 31 C.F.R. § 103.56.

7 *Id.* § 103.56(b)(6).

8 *Id.* § 103.56(b)(8).

2. Availability of the information.

Because of the notice requirement, FinCEN will have the first comprehensive list of its kind of unregistered investment companies. If other federal or state agencies will have access to the information, we request clarification on which agencies will have such access, and for what purpose.

Furthermore, we request clarification whether the information will be publicly available. We are aware that the Freedom of Information Act ("FOIA")[9] normally requires agencies to make information available to the public, unless such information falls under the exceptions listed in 5 U.S.C. § 552(b). Section 552(b)(8) excludes matters "contained in or related to examination, operating, or condition reports prepared by, on behalf of, or for the use of an agency responsible for the regulation or supervision of financial institutions." Because FinCEN's comprehensive list is for the purpose of regulating the AML programs of financial institutions, we believe the list should be free from FOIA disclosure.

D. The designated responsible AML person requirement for funds with no employees.

The Proposed Rules require the unregistered investment company to designate "a person (or committee) with the responsibility for overseeing the anti-money laundering program." The release accompanying the Proposed Rules state that the person responsible for the unregistered investment company's compliance program "should be one of its officers, trustees, general partners, organizers, operators or sponsors, as appropriate." Many Offshore Funds, however, have no officers or employees and will enlist a third party to conduct the AML program. For tax or other logistical reasons, it may not be possible for the fund's sponsor, organizer or adviser to be designated as the person responsible for overseeing the AML program. We request confirmation that such funds may fulfill this obligation by contracting with a third party service provider when appropriate or necessary in the context of the fund's structure. We further request confirmation that an entity may be the person responsible for overseeing the program.

E. The effective date of the regulation.

The Proposed Rules would require Offshore Funds to comply with the AML program requirement within 90 days of the adoption of the final rules. We request that the final rules include a longer phase-in period.

The new responsibilities and liabilities that would be imposed by the Proposed Rules would require amendment of agreements with third party service providers of a great number of Offshore Funds that are subject to the final rules. In the event that some service providers decline to undertake the new responsibilities and liabilities or accept them only after lengthy negotiations, the implementation of systems and procedures to ensure

[9] 5 U.S.C. § 552 (2000).

compliance with the new technical requirements may not be practical within the proposed time frame. Accordingly, the final rules should reflect a phase-in period of at least 180 days.

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We appreciate the opportunity to comment on FinCEN's Notice of Proposed Rulemaking on AML programs for Unregistered Investment Companies under Section 352 of the USA PATRIOT Act. If we can be of any further assistance in this regard, please do not hesitate to contact David A. Vaughan at (202) 261-3355, or, for specific questions regarding CDOs, Cynthia J. Williams at (617) 654-8604 .

Sincerely yours,

Dechert