

Know your customer

Recent legislation in the US and the UK puts hedge funds on alert

By Elise Coroneos and Patricia Ward

In response to events of September 11, both the US and the UK passed emergency legislation in an attempt to identify and filter out money suspected of being used to further terrorist activities. Amendments to the Terrorism Act 2000 in the UK have heightened obligations to report suspicions to the National Criminal Intelligence Service.

Meanwhile in the US, the USA PATRIOT Act requiring "financial institutions," including investment companies, to establish anti-money laundering programs, comes into effect on April 24, 2002. Passage of the act has left a lot of confusion in its wake. Ambiguity still remains as to whether a hedge fund is captured by the term "investment company" as it is used in the act, and if so, how its mandate need be achieved given the lack of regulatory guidance from the US Treasury.

"The indications that we have received from the Treasury is that they believe hedge funds are investment companies; however, there is nothing official on that point," says Ken Raisler, a partner at the law firm Sullivan & Cromwell, which was involved in drafting a preliminary guide for hedge funds on developing anti-money laundering programs, which was released by the Managed Funds Association.

Filtering clients

At the core of the US anti-money laundering legislation that is likely to most affect hedge funds is the level of knowledge a financial institution will be required to have about its customers.

Already, hedge funds have to review the names of existing investors against those on the Office of Foreign Assets Control's master list of "Specially Designated Nationals and Blocked Persons." Now, in addition to this practice, section 352 of the PATRIOT Act requires a financial institution to establish an anti-money laundering program that includes at a minimum, the devel-

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opment of internal policies, procedures and controls; the designation of a compliance officer; an ongoing employee training program; and an independent staff audit function to test programs.

Weiss Peck & Greer, a hedge fund manager/broker dealer, has already implemented a compliance program. "The changes are already in place," says chief compliance officer Robert Kloby.

"We've enhanced the 'know your customer' procedures in terms of making sure we get the beneficial owner of all accounts. We now systematically screen all of our accounts versus the government lists, and we went back and screened all of our existing client names against those restricted lists to make sure we didn't have any violations there."

Relying on third parties

While it is still unclear whether hedge funds need comply with the PATRIOT Act, better safe than sorry is the order of the day. To ensure they are covered by the coming regulations, the MFA guidance recommends that managers pay attention to their direct relationships with investors and those with intermediaries.

Hedge funds can currently accept investors from third-party providers without knowledge of the identity of the end investor. But with the PATRIOT Act coming into force, some legal experts have questioned whether this will be allowed to continue or it will be the end

of anonymous investing as we know it.

The act may result in the end of relationships with intermediaries who are not willing to provide the necessary customer identification to satisfy US requirements. Sullivan & Cromwell's Raisler cites the example of a hedge fund group that recently decided it would no longer deal with investors who introduce intermediaries on an undisclosed basis.

Martin Sklar, a partner at the law firm Kleinberg, Kaplan, Wolff, & Cohen, is currently advising hedge fund clients against nominees, that is institutions or individuals investing as an agent on behalf of an undisclosed principle. "Of course, a lot of the Swiss banks don't like to tell you who is investing," says Sklar.

"I don't know what is going to be acceptable from now on. That is one of the main things I am going to be looking for in the regulations."

To address this issue, Weiss Peck & Greer has obtained copies of its third-party administrators' procedures. "We've even requested documentation from them in terms of the types of support they are getting from clients," says Kloby.

A familiar story

In the UK, determining who is responsible for checking the identity of a customer has been a hard task. The recent merging of various UK finance sector regulatory bodies into one, the FSA, has led to rationalized rules on money laundering checks. Since these FSA rules came into effect in December last year, questions have been raised about their appropriateness and application.

According to Peter Astleford, an attorney with the London firm of Dechert, it is the hedge fund administrator rather than the hedge fund manager's compliance officer who is responsible for checking the credentials of investors in a fund. But, Astleford points out, if the administrator of the hedge fund does not know who the investor is or require further confirmation of identity, the adminis- **19►**