MANAGED FUNDS ASSOCIATION

VIA ELECTRONIC MAIL: regcomments@fincen.treas.gov

November 25, 2002

FinCEN
P.O. Box 39
Vienna, VA 22183-1618

Attention: NPRM – Section 352 Unregistered Investment Company Regulations

Dear Sir or Madam:

Managed Funds Association ("MFA") appreciates the opportunity to comment on the notice of proposed rulemaking, and accompanying release,(the "Proposed Rule") by the U.S. Department of Treasury ("Treasury") Financial Crimes Enforcement Network ("FinCEN") pursuant to Section 352 of the USA PATRIOT Act (the "Act") published on September 26, 2002 (67 Fed. Reg. 60617). MFA, located in Washington, DC, is the only U.S.-based global membership organization dedicated to serving the needs of professionals worldwide that specialize in the alternative investment industry—hedge funds, funds of funds and privately and publicly managed futures funds. MFA has approximately 500 members who represent a significant portion of the over $600 billion invested in alternative investment vehicles around the world. Accordingly, MFA, its members and the investors who invest in our members' funds have a vital interest in the Proposed Rule.

MFA strongly supports and seeks to assist the U.S. government's efforts to combat money laundering and the financing of terrorist activities. We support the application of Section 352 to unregistered investment companies. We believe that with clarification of certain provisions of the Proposed Rule, as set forth below, the application of Section 352 to unregistered investment companies will provide additional safeguards against money laundering.

The Proposed Rule requires certain investment companies not registered with the Securities and Exchange Commission ("SEC") to establish anti-money laundering ("AML") programs as specified under section 352 of the Act. The unregistered investment companies ("UICs" or "funds") covered by the Proposed Rule include, among other entities, hedge funds and commodity pools. Under the Proposed Rule, these UICs must establish an anti-money laundering program that includes, at a minimum: (i) the development of internal policies, procedures, and controls; (ii) the designation of a compliance officer (an "AML Compliance Officer"); (iii) an ongoing employee training program; and (iv) an independent audit function to test programs.

Introduction: Industry Practice

As in the banking and mutual fund industries, UIC managers often rely on third parties for the introduction of investors and the processing of fund investments and subscription documents. For example, investor intermediaries and nominees may introduce their investor clients to a hedge fund or may invest in hedge funds on their clients' behalf. Similarly, a "fund of funds" may make investments in a hedge fund on behalf of its investors. In addition, UICs typically rely on their fund administrators for the processing of subscription documents and compliance with anti-money laundering laws and regulations applicable in the fund's jurisdiction of organization.

These third parties often have direct contact and maintain the primary relationship with the investor and are consequently in the best position to "know the customer". As a result, a UIC may, directly or indirectly, rely upon the investor identification and verification procedures performed by such third parties.[1] Given the complexity and importance of appropriately allocating investor identification and verification responsibilities to such a third party, the AML Compliance Officer would be aided by sound regulatory guidance in making the decision to rely upon a particular third party to perform investor due diligence. MFA seeks to offer FinCEN suggestions to help formulate such guidance.

MFA Support of Efforts to Combat Terrorist Financing and Money Laundering.

MFA strongly supports the Treasury's efforts to combat money laundering and the financing of terrorist activities. Since the passage of the Act, MFA has had frequent discussions with officials from Treasury and other affected agencies to discuss the implementing regulations. One of the central points in these discussions has been recognition of the importance of the ability of UICs to rely on the AML compliance programs of intermediaries, including third-party administrators. Accordingly, in March 2002, MFA published its "Preliminary Guidance for Hedge Funds and Hedge Fund Managers on Developing Anti-Money Laundering Programs" which may be amended from time to time (the "MFA Guidance"). The MFA Guidance provides our members with the necessary tools to develop internal policies and procedures for their own AML programs, which we believe are consistent with the Proposed Rule. The MFA Guidance provides detailed information on how to rely on third-party administrators who conduct "Know Your Customer" ("KYC") checks and other due diligence on behalf of hedge funds and other alternative investment funds. Moreover, the MFA Guidance recognizes the critical role of

[1] The AML rules of many jurisdictions in which offshore fund administrators operate provide for "travel rules" on which such offshore administrators can rely upon for the majority of the capital transactions (subscriptions, redemptions and transfers) of the funds administered by offshore firms. The so called "travel rules" essentially provide that if the subscriber is remitting its subscription monies from an account in its name with a qualifying financial institution in an FATF-compliant jurisdiction, and absent any suspicious circumstances, the offshore administrator can rely on the identification procedures and verification conducted by that qualifying financial institution when the subscriber opened its account with that institution, and do not have to further identify the subscriber. There are also other certain exceptions, for instance where investors are themselves qualifying financial institutions, or where the investor is introduced by a qualifying financial institution and those parties make certain representations about the institution. MFA's anti-money laundering guidance, discussed herein, is premised upon the ability to rely upon such rules.

carrying out an effective AML program and how to determine the effectiveness of a third party's AML programs. MFA is now taking the opportunity, among other things, to suggest ways that some of the practical advice set forth in the MFA Guidance could be incorporated by FinCEN in the final rule or its preamble to any adopting release impacting UICs under the Act.

Delegation of Anti-Money Laundering Compliance Responsibility to Third Parties

The Proposed Rule acknowledges that UICs conduct their operations through contractual third-party service providers, such as fund administrators or investment advisers, and accept investments through intermediaries (such as fund-of-funds and bank nominee companies). The Proposed Rule further acknowledges that UICs can delegate the implementation and operation of elements of the mandatory anti-money laundering compliance program (the "AML Program") to such third parties. The legislative history and the language of Section 352(c) of the Act itself suggest that in adopting AML programs, "one size does not fit all." Section 352(c) of the Act specifically states that "… the Secretary shall prescribe regulations that consider the extent to which the requirements imposed under this section are commensurate with the size, location, and activities of the financial institutions to which such regulations apply." Different practices both within and among members of the financial service industry, both within the U.S. and offshore, must be recognized and taken into account in developing an AML program.

Third-parties both in the U.S. and offshore, would be unlikely to accept delegation of the implementation and operation of a fund's *entire* AML Program. It is more likely that the responsibilities and duties under a fund's AML Program will be split among several third parties. This will involve careful negotiation of the AML Program and contractual delegation in the agreements with such third-parties so that the responsibilities of each entity engaging in AML procedures are clearly allocated and documented.

Under the Proposed Rule, if UICs wish to delegate responsibility for aspects of the AML Program to a third-party, then, among other requirements:

1. They will remain fully responsible for the effectiveness of that party's AML Program; and

2. They must ensure that "federal examiners are able to obtain information and records relating to the anti-money laundering program and to inspect the third party for the purposes of the program".

We will address each item separately below. MFA believes that FinCEN needs to elaborate further, in any adopting release, on how these requirements can be satisfied.

1. **Responsibility for Third Party's AML Program.** With respect to the first point above, the Proposed Rule implies that if AML Program duties are delegated to third parties, and such third parties failed to meet the requirements of Section 352, then the fund would be held to a strict liability standard for noncompliance with the Act. MFA believes that UICs should be able to satisfy the requirements of the Act if they, for example, conduct the primary steps that we

have laid out in the MFA Guidance. For instance, FinCEN should find acceptable the case where a fund establishes a policy providing that it will generally rely upon the investor identification (or KYC) and verification procedures performed by third parties, with respect to the fund's investors, such as one of the following (or an entity, all of the beneficial owners of which are):

- A U.S.-regulated financial institution where the investor is a customer of that institution and the investor's investment funds are wired from its account at that U.S.-regulated financial institution, or an affiliate under common control of such U.S. financial institution;

- An investor intermediary, nominee, fund of funds or asset aggregator that is itself a U.S.-regulated financial institution or exempt from registration pursuant to Sections 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940 and subject to FinCEN anti-money laundering obligations;

- A tax exempt organization described in Section 501(c)(3) of the Internal Revenue Code;

- A public company whose shares are listed on a recognized exchange in a FATF-compliant jurisdiction, or a subsidiary or pension fund of such a public company;

- A private pension fund which is subject to the Employee Retirement Security Act; or

- A foreign financial or investment institution organized in a FATF-compliant2 jurisdiction, or that is a subsidiary, affiliate or under common control with such institution. To the extent that the hedge fund manager believes that the investor identification and verification procedures performed by a foreign financial institution, although reliable, may not include procedures that the hedge fund manager is required to perform, e.g., verification of whether an investor is a "Listed Investor" whose name appears on Treasury's list in the Office of Foreign Assets Control ("OFAC"), the hedge fund manager should either expressly request that the foreign financial institution confirm that it has performed the necessary additional procedures or otherwise provide for the performance of such procedures prior to accepting an investor through that financial institution.

In addition, FinCEN could, in any adopting releases, set forth the following options laid out in the MFA Guidance for cases where third-party administrators do not meet the above-stated criteria (and absent any suspicious circumstances):

- Requiring the third party to provide the hedge fund manager with a copy of its anti-money laundering and investor due diligence policies, procedures and controls and to promptly notify the hedge fund manager of any amendment thereto.

- Requiring the third party to certify and covenant that it complies and will continue to comply with its anti-money laundering and investor due diligence policies, procedures and controls.

- Requiring meaningful written representations and covenants of the third party as to investors verified by the third party, e.g., a covenant that it will ensure that no such investors are prohibited Listed Investors, such as those prohibited by OFAC.

- Requiring the third party to provide access, upon request, to copies of documents reviewed by the third party in performing investor due diligence.

- Requiring the third party to submit to an independent review or audit of its anti-money laundering policies, procedures and controls and its compliance with them as they relate to the funds managed by the hedge fund manager and to provide the results of such a review to the UIC.

- In the case of an intermediary or nominee, obtaining evidence of or representations as to its authority to make the contemplated investment.

The MFA Guidance also provides sample agreement language to assist our members in allocating AML duties among the unregistered investment company, the third-party administrator and investor representatives. For instance, in the MFA Guidance's Sample Provisions for Fund Administrators, we suggest that fund administrators essentially make the following representations and covenants with respect to its own AML program:

- The administrator has adopted and implemented anti-money laundering policies, procedures and controls that comply and will continue to comply in all respects with the requirements of applicable anti-money laundering laws and regulations in its home country jurisdiction.

- The administrator has provided the hedge fund manager with a copy of its anti-money laundering policies, procedures and controls, and will promptly provide the hedge fund manager with any material amendment thereto. Alternatively, the hedge fund manager may wish to incorporate the administrator's anti-money laundering policies, procedures and controls into its agreement with the administrator so that the administrator's anti-money laundering policies, procedures and controls could only be amended with the consent of the hedge fund manager.

- The administrator strictly adheres to, and will at all times during its relationship with the hedge fund manager strictly adhere to, its anti-money laundering policies, procedures and controls.

- The administrator agrees to submit, at its own expense, to an independent audit to assess its compliance with and the effectiveness of its anti-money laundering policies, procedures and controls.

These suggestions in the MFA Guidance illustrate that MFA has encouraged our members to comply with AML procedures. We believe FinCEN should consider this advice in promulgating future regulations, or adopting releases, in requiring UICs to comply with the Act.

2. U.S. Federal Examination Authority. The Proposed Rule also requires that federal examiners be able to inspect a third party delegatee's records for the purposes of the UIC's AML Program. Federal inspection authority is not specifically delegated in the Proposed Rule, and the default inspection authority for Treasury lies with the Internal Revenue Service ("IRS").[3] We believe that FinCEN should specifically delegate this authority to an appropriate government agency in the Proposed Rule, as discussed below.

a. Offshore Third Party Administrators. With respect to third-party administrators, one concern is the requirement in the Proposed Rule that funds will have to ensure that third-party delegatees will provide information and records to, and make themselves available to inspection by U.S. federal examiners. By "information and records" relating to the AML Program, we assume this could include underlying shareholder records as these would form part of the records and information relating to the implementation of the AML Program. As drafted under the Proposed Rule, U.S. federal examiners would be able to access confidential shareholder information of offshore funds. Administrators and investment managers located in non-U.S. jurisdictions will become subject to U.S. jurisdiction and inspection by U.S. federal examiners. The scope of this requirement is unclear. This extra-territorial jurisdictional reach by U.S. federal examiners is obviously of great concern, particularly to offshore fund administrators and to non-U.S. investors in offshore funds, and we believe it will have a detrimental effect on the hedge fund industry. FinCEN should explain how it proposes that U.S. federal examiners will enforce these provisions and obtain access to the information which will be, for the large part, maintained offshore. MFA encourages FinCEN to take a les intrusive approach such as that set forth in the MFA Guidance.

To the extent that inspection authority under the Act would require giving the U.S. government access to account-specific information maintained by an offshore administrator, we believe this is unrealistic and serves no reasonable purpose. Third-party administrators located outside the U.S. will not likely agree to divulge confidential, account-specific information to U.S. authorities unless compelled to do so by their local government. Indeed, such an agreement would generally violate applicable contract provisions and local law. Instead, the focus of this requirement should be to insure that the UIC has acted reasonably in delegating its AML Program responsibilities to the third-party administrator (whether in the U.S. or offshore). As mentioned above, MFA Guidance offers members of the alternative investment industry specific guidelines for relying on a third party's compliance with AML rules. We believe that upon examination, a UIC should be found to be in compliance with its AML obligations if it has obtained certificates confirming that it has taken the following steps:

1. Delegated AML responsibilities to a third party that is located in a FATF-compliant jurisdiction, or a subsidiary, affiliate or under common control with such third party;

[3] 31 CFR 103.56(b)(8).

2. Obtained a certification that the third party has complied with the AML requirements of its own jurisdiction;

3. Reviewed and retained a copy of the third party's AML Program; and

4. Audited the third party administrator's AML Program and procedures and has documented such audit. It should be clear in the final rule, however, that such third party administrator is not required to turn over account-specific information to U.S. federal examiners (particularly with regard to non-U.S. investors).

b. Commodity Pool Operators. One other final point concerning federal inspection authority relates to funds operated by commodity pool operators ("CPOs"). The National Futures Association ("NFA") has already agreed to perform that function for registered CPOs. As drafted, the IRS would be the default agency for inspection of records under the Act. However, we believe that the NFA, or the Commodity Futures Trading Commission, should be the proper inspection authority for CPOs to determine their compliance with the Act.

Additional Issues Related to Third-Party Delegation of AML Duties Under the Act

We would also like to address other concerns with respect to third party delegation, with particular emphasis on the offshore administrator community, vís a vís: (1) confidentiality laws and policies, and (2) offshore financial centers.

1. Confidentiality Laws. Most of the jurisdictions in which offshore administrators provide services to funds have strict confidentiality laws which require offshore administrators and the relevant funds to maintain any shareholder records as confidential, save for the ability to disclose information in certain circumstances, including pursuant to: (a) the shareholder's consent, (b) a request by a regulatory authority having jurisdiction over the fund or the administrator (e.g., by the Cayman Islands Monetary Authority ("CIMA"), the Central Bank of Ireland ("CBI"), the Bermuda Monetary Authority ("BMA"), etc.); or (c) a court order issued by a competent court in the relevant jurisdiction. If U.S. federal examiners find cause for concern to go beyond the certificates of compliance relied upon by UICs (as suggested above), then any requests by such examiners for detailed shareholder information should be made through the appropriate regulatory authorities in the applicable jurisdiction. For instance, the U.S. federal examiners would have to make the request for records inspection through CIMA, CBI or the BMA, and not directly upon the offshore administrators, showing cause for why they believe U.S. anti-money laundering laws may have been violated.

2. Offshore Financial Centers. It should also be noted that offshore financial centers are not necessarily lax with respect to anti-money laundering requirements. Footnote 31 in the Proposed Rule makes reference to the Working Group Report and states "that a significant number of hedge funds are established in offshore financial centers that are tax havens and may be engaged in illegal tax avoidance and similar unlawful activities." Although a number of hedge funds may be established in offshore financial centers, many of these offshore financial centers,

including Bermuda and the Cayman Islands, have sophisticated and rigorous anti-money laundering rules applicable to investors in such vehicles. Third-party administrators located in these jurisdictions have already implemented anti-money laundering systems and procedures that are significantly more advanced than those employed by most U.S. investment companies.

Overall, we believe that the final rule should more clearly define the parties to whom the AML Program of a fund can be delegated, and the responsibilities of each such delegatee. MFA believes that any investor identification and verification aspect of the AML Program can be delegated to the fund's offshore administrator. The AML Compliance Officer should be responsible for communicating information to federal examiners about the fund's AML Program and its implementation, but not detailed shareholder information which is subject to confidentiality laws. In this way, if federal examiners wished to make inspections, they would be able to inspect the offices of the UIC that is subject to the Act by meeting with the AML Compliance Officer.

Notice Requirement

The release accompanying the Proposed Rule states that, because many UICs are not necessarily registered with or identifiable by FinCEN or other financial regulators, the only way for FinCEN to assure such companies are in compliance with the Act is to require that they file a short notice identifying themselves and providing basic information about their company.

1. Who Should File. MFA believes that the notice requirement should be limited to entities that have outside investors and not include each subsidiary of an investment fund or vehicle. For example, in a typical "master-feeder" structure, various "feeder funds" are created to accept investments from outside investors. Each "feeder fund" then contributes its assets to a common "master fund," which may itself form various subsidiaries through the actual investments are made. MFA believes that it is appropriate to require the "feeder funds," which accept money from outside investors, to submit the required notice to the U.S. government. It would be confusing and unnecessary, however, to require a notice filing by the master fund and each of its various subsidiaries, even though each of these entities is technically an "unregistered investment company."

2. Public Access to Filings. We are concerned about the confidentiality that will be provided for these notice filings. It is clear that as a result of these rules, Treasury will obtain a comprehensive list of hedge funds for the first time. For a number of reasons, we believe that, if such notice is required, it should be protected from public access under the Freedom of Information Act. If the notice can be obtained by the public, we would be concerned about privacy as well as other issues.

3. Registered Commodity Pool Operators. MFA would also like to address the issue of notice filings by funds operated by registered CPOs. We believe that such funds should be exempt from the notice filing requirement and that the NFA be used as the source for information about those pools. The NFA, in its comment letter submitted to FinCEN, addresses this issue in greater detail and MFA concurs with their analysis.

4. Assets Under Management. Assets under management of UICs may vary materially from time to time. As a result, rather than state the specific amount of assets under management, we recommend that the assets be reported on the notice filing within a certain range. Thus, MFA would like to suggest that the form be amended to provide boxes for us to check off assets within a certain range (for example: $100M-500M, over $500M, etc.).

Independent Testing of the AML Program

The Proposed Rules provide that a periodic audit of the fund's AML Program must be conducted, and that the audit can be carried out either by employees of the relevant fund, or by employees of affiliates of the fund or unaffiliated service providers, provided that the individuals are not involved in the operation or oversight of the AML Program. The tests have to be conducted by persons knowledgeable with the Bank Secrecy Act's requirements, and can not be conducted by the fund's AML Compliance Officer.

It is unclear from this as to who will be the most appropriate person to conduct the audit. Clearly, the audit should not be conducted by the administrator which is performing the investor identification and verification procedures for the fund. Non-U.S. based auditors to offshore funds are also not going to be familiar with Bank Secrecy Act ("BSA") requirements. Further, most investment managers are not going to have sufficient employees well versed in the BSA's requirements and will also most likely be providing the fund's AML Compliance Officer (who as noted above cannot conduct the audit under the Proposed Rules). Accordingly, MFA suggests that FinCEN adopt essentially the same language from MFA's Guidance on the independent audit requirement in any adopting releases. The independent audit function should involve:

- Evaluation by the fund manager's legal and compliance director or officer or by external auditors (accounting firms, financial investigation firms or other similarly competent professionals) or counsel of compliance with applicable anti-money laundering laws and regulations and the fund manager's own anti-money laundering program; and

- Reporting of the results of such evaluation to the appropriate oversight body of the fund manager.

- Appropriate follow-up to ensure that any deficiencies detected in the course of the audit of its anti-money laundering program are addressed and rectified.

The UICs AML Program should also provide for appropriate follow-up to ensure that any deficiencies detected in the course of the audit of its anti-money laundering program are addressed and rectified.

Ongoing Training

The Proposed Rule requires that UICs also provide for ongoing AML training for appropriate persons. MFA recommends that FinCEN, in any adopting releases, follow the suggestions in the MFA Guidance stating that AML training programs, among other things:

- Review applicable anti-money laundering laws and regulations and recent trends in money laundering, including the ways in which such laws and trends relate to hedge funds; and

- Address elements of the hedge fund's own anti-money laundering program, particularly its investor identification procedures and policies regarding detection of suspicious activity.

In addition, the manager of the fund should be required to develop and maintain policies, procedures and controls reasonably designed to ensure that all appropriate personnel attend the anti-money laundering training programs as required.

FinCEN should also require that records of all anti-money laundering training sessions conducted, including the dates and locations of the training sessions and the names and departments of attendees, should be retained for at least five years, or for such longer period as deemed appropriate.

Commodity Pool Operators

Many UICs covered by the Proposed Rule are operated by CPOs registered under the Commodity Exchange Act. CPOs are specifically listed as "financial institutions" under Section 352 of the Act. Moreover, a CPO may only accept customers and customer funds into the commodity pools operated by the CPO. Thus any anti-money laundering program adopted by a CPO would necessarily be with respect to its commodity pools. It will be important for Treasury, or FinCEN, in drafting any further rules under Section 352, to take into account the broad coverage of the Proposed Rule and the fact that the obligations of CPOs cannot be separated from obligations of the pools that they operate. This would be necessary to avoid unnecessary burdens on CPOs, including, perhaps, duplicative application of AML Program requirements with respect to the same customer investing in the same fund.

General Comment Regarding Definition of "Unregistered Investment Company"

Another comment to the Proposed Rule concerns the application of the term "unregistered investment company." It is unclear from the Proposed Rule whether the inclusion of "unregistered investment companies" within the definition of "financial institution" would apply only to Section 352 or also apply to all other Act and Bank Secrecy Act provisions that use the term "financial institution". We believe that section 103.132(a) should be revised to replace the word "section" with the word "Subpart" to clarify that the new definition applies only to Section 352.

Section 326 of the Patriot Act

Finally, FinCEN in its commentary on the Proposed Rule noted that UICs may become subject to more detailed requirements regarding investor identification and verification under rules to be issued under Section 326 of the Act. We look forward to participating in any such rulemaking.

If you have any particular questions about the issues MFA has raised in connection with the Proposed Rule, please contact me at 202.367.1140.

Sincerely,

John G. Gaine
President