

## The USA PATRIOT Act and Its Effect on Private Equity Funds

On October 26, 2001, President Bush signed into law the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001. This law, passed in partial response to the events of September 11, 2001, is better known by its acronym, the USA PATRIOT Act (also known simply as the "Patriot Act"). The law was enacted as a legislative attempt to combat terrorism behind the scenes by attacking terrorists' ability to access and move funds used in support of terrorist activities.

Of particular relevance to private equity funds is Article III of the Patriot Act, entitled the International Money Laundering Abatement and Anti-Terrorist Financing Act of 2001 (the "IMLA"). This portion of the Patriot Act includes a series of aggressive new anti-money laundering provisions that are meant to apply to "financial institutions."

Prior to enactment of the Patriot Act, federal anti-money laundering laws applied to a limited number of financial institutions, primarily traditional banks. The new law expands the definition of "financial institutions" dramatically, now including within its reach "investment companies." As a result, private equity funds will likely fall within the anti-money laundering provisions of the IMLA.<sup>1</sup>

The IMLA directly affects the fund raising efforts, operations and new investment initiatives of private equity funds. The anti-money laundering scheme set forth in the IMLA has several components of which our fund clients should be aware.

### Formal Anti-Money Laundering Programs

The IMLA calls for financial institutions to establish anti-money laundering programs by April 24, 2002. Such programs, at a minimum, must include:

- Internal policies, procedures and controls designed to detect and prevent money laundering
- The designation of an internal compliance officer
- An ongoing employee training program
- An independent audit function to test the effectiveness of the anti-money laundering program

While the IMLA does not provide any additional details regarding the content or operation of an acceptable anti-money laundering program, private equity firms should make a good-faith effort to comply with these minimum standards. The National Venture Capital Association (NVCA) is currently developing best practices and guidelines for private equity firms in designing a formal anti-money laundering program. Until a standard set of policies and procedures is established, we believe that the following elements should be part of your program:

- A policy statement expressing the fund's intent to comply with all applicable laws and regulations designed to combat money-laundering
- Reporting suspicious activities (such as an unusual volume of wire transfers or transactions with suspect countries) of any investor or portfolio company to the designated compliance officer

- Requiring all investors to make representations concerning the legitimacy of their investments
- Before accepting new investments, cross-referencing investors with lists of known and suspected terrorists maintained by the Office of Foreign Asset Control (OFAC)
- Ensuring that all distributions of funds are made only to the owner of an interest in the fund as shown on its books and records
- Requiring the compliance officer to discuss the above procedures with all personnel employed by the fund
- Requiring the policies and procedures to be updated periodically, not less frequently than once a year

### "Know Your Investor" Standards

By October 25, 2002, the Treasury Department is directed to promulgate regulations prescribing minimum standards relating to verification of customer identities. These requirements are likely to be similar to those currently imposed on banks. Under the Patriot Act, private equity funds could be required to investigate and determine (1) the source of all investments coming into the fund, (2) the occupation and corporate affiliations of each investor and (3) all lending relationships of each investor. Similar inquiries into the activities of each portfolio company's officers, directors and investors may also be required.

### Suspicious Activity Reporting

Regulations under the IMLA require registered broker-dealers to submit reports detailing "suspicious" transactions or account

activity, including anomalous transfers or transactions with no apparent business purpose. These suspicious activity reports are currently also required to be filed by banks pursuant to the Bank Secrecy Act.

This requirement is noteworthy to private equity funds because the IMLA directs the Treasury Department, by October 25, 2002, to submit a report to Congress recommending regulations to extend the requirements of the Bank Secrecy Act to "investment companies" as defined by the Investment Company Act of 1940 (including those entities that are not considered "investment companies" due solely to the exceptions contained in Sections 3(c)(1) and 3(c)(7) of the Investment Company Act). As a result, private equity firms could be required to file suspicious activity reports and keep records of various financial transactions.

As final regulations implementing the IMLA are issued, the full impact of this new law on private equity funds will be clarified. We will keep you abreast of the new developments. In the interim, we welcome the opportunity to discuss with you the above matters and their relevance to your business.

This information is a general description of the law and is not intended to provide specific legal advice. If you would like further analysis or explanation, please contact your Cooley attorney or one of our offices listed below. ■

### Notes

<sup>1</sup> The Patriot Act authorizes the Treasury Department to issue clarifying regulations regarding the duties owed by particular financial institutions. To date, no such regulations have been issued that address the duties owed by private equity firms.

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