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AML Best Practices for Private Funds: Red Flags and Responses for Private Funds

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U.S. hedge funds, private equity funds, and venture capital funds (collectively, the Private Funds)[2] and their U.S. general partners, sponsors, and managers (Advisers) are not directly subject to the Bank Secrecy Act of 1970 and its amendments (BSA), as previously discussed in Lowenstein Sandler's client alert, "Anti-Money Laundering Best Practices for Private Fund Managers: The Prudence of Establishing an AML Compliance Program," dated February 17, 2023. Advisers are encouraged to implement a risk-based anti-money laundering (AML) compliance program similar to those implemented by financial institutions and with whom the Advisers and Private Funds engage with on a regular basis for multiple transactions (e.g., custody, loan, trading, banking, and other activities). An Adviser's implementation of a risk-based AML compliance program is considered a good business practice and aligns with standard industry practices.

In connection with implementing an AML compliance program, set forth below are discussions and examples of red flags (i.e., unusual investor behavior or transactional activity) related to investor activity, but a robust AML program should include reviews of counterparties and investment activities as well.

Red flags may be discovered during an initial investor onboarding, or from ongoing due diligence reviews that occur after the investor has been accepted as a Private Fund investor. Red flags also may be discovered through regular transaction monitoring and periodic or event-driven know-your-customer (KYC) reviews. Where a red flag remains unresolved after investigation, the Adviser will have the option of redeeming the investor's interests and off-boarding the investor. Reporting red flags to appropriate law enforcement or regulatory authorities may be required or recommended in certain situations. All red flag reviews should be undertaken in accordance with the Adviser's AML compliance policies and procedures.

A. Red Flag Investors

Advisers may encounter various investor types that present red flags during onboarding and/or ongoing due diligence reviews. With respect to any of the scenarios set forth below, the designated individual responsible for overseeing the Adviser's AML compliance program (AML Officer) should consult with general counsel and/or outside counsel as required.

Set forth below are examples of red flags that may be encountered during initial onboarding or subsequent periodic reviews of an Adviser's Private Fund investors and require additional investigation:

1. **Domicile in FATF Countries**
Investors are from a country on the Financial Action Task Force (FATF) list of High-Risk Jurisdictions Subject to a Call for Action (FATF Blacklist),[3] the FATF list of Jurisdictions Under Increased Monitoring (FATF Greylist),[4] or investors are from a jurisdiction that is not a FATF participant (regional or otherwise).

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[1] Special thanks to Diana Faillace, Deputy General Counsel, Director at Cerberus Capital Management and former senior counsel at Lowenstein Sandler, for her contributions to this alert.
[2] For the purposes of this article, "Private Funds" applies to privately placed pooled investment vehicles exempt from registration under the Investment Company Act of 1940 and managed by registered investment advisers, exempt reporting advisers, or nonregistered investment advisers.
[3] The FATF Blacklist is a list of countries which the FATF judges to be non-cooperative in the global fight against money laundering and terrorist financing, referred to as Non-Cooperative Countries or Territories. FATF Blacklist countries have significant strategic deficiencies in their regimes to counter money laundering, terrorist financing, and financing proliferation of illegal activities related to nuclear, chemical, or biological weapons. See FATF High Risk Jurisdictions Subject to a Call for Action – 21 October 2022; https://www.fatf-gafi.org/content/fatf-gafi/en/publications/High-risk-and-other-monitored-jurisdictions/Call-for-action-october-2022.html.
[4] FATF Greylist countries are countries that have strategic deficiencies in their AML compliance regime but have committed to work with the FATF to swiftly address such strategic deficiencies within agreed timeframes. See FATF Jurisdiction Under Increased Monitoring – 21 October 2022; https://www.fatf-gafi.org/content/fatf-gafi/en/publications/High-risk-and-other-monitored-jurisdictions/Increased-monitoring-october-2022.html.

a. FATF Blacklist – Many Advisers decline investors or investor capital commitments from FATF Blacklist countries. While there is no blanket ban, the Adviser's risk appetite and the ability to implement enhanced due diligence (EDD)[5] and other additional controls are key considerations when determining whether to onboard or maintain such an investor.
b. FATF Greylist – The fact that a country is on the FATF Greylist is not determinative of a requirement to offboard the investor, but rather depends on the totality of facts discussed during the due diligence review. For instance, the Cayman Islands is currently on the FATF Greylist. While Cayman Islands entities may present red flags in a KYC review, an EDD review of such an entity may resolve any risk or other AML issues that may arise.
c. Non-FATF Participants – Investors from countries not participating in the FATF should be reviewed by the Adviser on a case-by-case basis.

Capital commitments should not be received from any FATF Blacklist country or from shell banks.[6] Capital commitments from a FATF Greylist country should be reviewed and approved by the Adviser's AML Officer on a case-by-case basis.

2. Source of Funds and Source of Wealth
An investor's income should be commensurate with the amount of capital commitment being deployed for an investment in a Private Fund. An investor's capital commitment and the reasonable ability of such investor to fulfill their commitment should be reconciled based on the investor's source of funds and/or wealth. Any attempts to obscure or evade the Adviser's reconciliation efforts should be identified for further review. Where an investor's source of funds or source of wealth is from (i) a jurisdiction listed on the FATF Blacklist or FATF Greylist or (ii) a jurisdiction that is not a FATF participant (regional or otherwise), additional review is required.

3. Politically Exposed Persons
Investors who are Politically Exposed Persons (PEP)[7] warrant further review to determine the extent of AML risk posed by their PEP status. A PEP designation does not automatically make an investor high-risk or preclude the acceptance of such an investor into the Private Fund. However, the Adviser should determine the nature of the PEP position and the country or non-governmental organization (NGO) involved. Factors to consider when determining whether to onboard or maintain a PEP investor include:

a. Opportunities for corrupt practices based on the nature of the public function (e.g., theft, embezzlement, involvement in organized crime) and misuse of public funds.
b. Level of prominence of the public position and sphere of influence.
c. Negative news associated with the PEP.
d. Level of corruption associated with the country or NGO that the PEP holds or held office.
e. Whether the PEP is considered a former PEP[8] or still actively performs a public function.

4. Persons Affiliated with Politically Exposed Persons
An investor related to or affiliated with a PEP (indirect PEP) may be considered higher risk notwithstanding such investor's own non-PEP status and warrant further review to determine the nature of such investor's relationship to the PEP and the PEP's domicile. The risks of an indirect PEP can include use of the affiliate or close associate to conceal the PEP's involvement in the transaction or to otherwise conduct transactions that are truly for the benefit of or at the direction of the PEP. Similarly, the affiliate or close associate of the PEP may exercise undue influence over the PEP.

5. Adverse News
Investors that have material negative/adverse news alerts warrant further review to determine the extent of their AML risk posed by such alert. Red flags may be discovered during negative news searches that Advisers or the Private Fund's administrators should consider undertaking as part of ongoing due diligence reviews. Material negative news typically includes news of possible criminal, civil, or regulatory indictments and enforcement actions; allegations of bribery, payoffs, or kickbacks; or any other news that could present a reputational or legal risk to the Adviser or Private Fund if the investor remains in the Private Fund.

6. Sanctioned Persons and Jurisdictions
Investors who are Specially Designated Persons (SDNs) on the Department of the Treasury's Office of Foreign Assets Control (OFAC) sanctions list or sanctions lists issued by other U.S. or foreign regulatory agencies require specific legal review. All U.S. Persons[9] have an obligation to comply with OFAC sanctions.

Private Funds should not onboard investors identified on the SDN list. To the extent an investor has already been onboarded and/or is subsequently added to

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[5] With respect to EDD, please see Lowenstein Sandler's client alert on "AML Best Practices for Private Fund Managers: The Prudence of Establishing an AML Compliance Program."
[6] The FATF defines "shell bank" as a bank that has no physical presence in the country in which it is incorporated and licensed, and which is unaffiliated with a regulated financial group that is subject to effective consolidated supervision.
[7] A PEP has historically been defined as a foreign individual who is or has been entrusted with a prominent public function, as well as their immediate family members and close associates. However, the FATF broadly defines a PEP as "an individual who is or has been entrusted with a prominent public function," and most financial institutions have begun to include domestic individuals in their PEP designations. Note that once an individual is determined to be a PEP, they may always be considered a PEP by the financial institution. However, in many instances, the financial institution's risk rating is subject to change based on whether the individual is still entrusted with the public function.
[8] There is no institutional definition of a former PEP. However, a former PEP is generally referred to as an individual who no longer holds the public function from which the original PEP classification was derived. Many U.S. FIs will not "declassify" a PEP regardless of length of time the individual has been out of office. However, European Union AML regulations declassify PEPs after the individual has been out of office for 12 months.
[9] U.S. Person is defined as all U.S. citizens and permanent resident aliens regardless of where they are located, all persons and entities within the U.S., and all U.S. incorporated entities and their foreign branches. Under certain sanctions programs, foreign subsidiaries owned or controlled by U.S. companies or foreign persons in possession of U.S.-origin goods must comply.

OFAC's SDN list, or is from a jurisdiction or region that becomes the subject of OFAC sanctions after the onboarding, outside counsel should be contacted to determine next steps in accordance with applicable sanctions regulatory requirements.

Advisers and Private Funds transacting with SDNs, whether knowingly or without knowledge, risk incurring substantial fines levied by OFAC pursuant to OFAC's strict liability regime. KYC and effective ongoing compliance controls are essential to complying with sanctions laws and their specific reporting requirements. If an Adviser or their Private Funds are subject to sanction regimes in multiple countries, such lists from applicable jurisdictions should be added to the Adviser's reviews. Prominent sanctions lists include those issued by the United Kingdom, European Union, and United Nations.

7. Nature of Business/Industry
Investors that have difficulty describing the nature and purpose of their business with appropriate specificity, or lack knowledge of their purported industry, require additional investigation. Such investors may be fronting for third parties or may be attempting to obscure illegal funds.

8. Excessive Investor Interest or Resistance to KYC
Investors who express unusual concerns regarding, or hesitation to provide standard KYC information to fulfill, the Adviser's AML compliance program requirements necessitate additional investigation. This includes investor reluctance or refusal to provide information on the ultimate beneficial owner (UBO) of the investor's interests and collection of customer identification program requirements. This reluctance/resistance may indicate problematic hidden activity. Potentially, the investor may be acting as an agent for an undisclosed third-party, or this may indicate an attempt to obscure the true UBO, source of funds/wealth, or other issues. UBO determination is especially important for OFAC compliance.[10]

9. Lack of Interest in Investment Program
Investors that are uninterested in the Private Fund's investment strategy and related risks may indicate an underlying intent to legitimize illegal funds by investing in the Adviser's Private Fund without regard to true investment activity and returns.

10. Unusual Investor Activity
Investors who request repeated transfers of their interest to third parties or repeated changes in bank information may indicate that the investor is not the actual owner of the investment. The Private Fund, without sufficient justification from the investor (e.g., death, succession, merger, validated intervening event), should not distribute funds to any account other than the accounts listed on the investor's original subscription document.

Depending on the totality of the due diligence review, if an investor presents any of the foregoing red flags, the AML Officer should investigate further and determine whether to (i) decline to onboard the prospective investor or have the current investor's investment redeemed or (ii) subject the investor to EDD review to mitigate any perceived AML risk. Advisers should holistically review and determine solutions to the foregoing scenarios based on their risk appetite and AML compliance policies and procedures. Outside counsel should be consulted as necessary.

B. Red Flag Transactions

While the illustrations set forth in Section A are examples of investors that Advisers may encounter during Private Fund onboarding or in the course of a relationship with an investor, set forth below is a non-exhaustive list of types of potentially suspicious transactions that Advisers may encounter while monitoring the Private Fund accounts of existing investors and that may require a reassessment of the investor's AML risk profile. In certain cases, any reassessment may lead to a determination that the relationship should be terminated with such investor and their interests redeemed. If the Adviser is unsure about whether the investor warrants a higher risk profile or off-boarding based on specific transactional activity that presents a red flag, the AML Officer should consult with its general counsel or, as necessary, outside counsel for further guidance.

Note that with respect to any investor's interests potentially being redeemed due to OFAC or other sanctions restrictions, outside counsel should be consulted to determine whether the investor's funds should be blocked or may be returned, or whether other action is warranted.

Set forth below are examples of transactional red flags that may be encountered during the life of a Private Fund:

1. Investor's account has money coming from or going to any third parties.
2. Investor requests to engage in investments inconsistent with their stated strategy or with prior investments.
3. Investor funds are coming from or going to banks in U.S. or foreign jurisdictions or regions which the investor has no legitimate business or personal ties.
4. Investor requests the transfer of funds into or out of their accounts to accounts in U.S. or foreign jurisdictions or regions far removed from their stated place of business or domicile.
5. Investor requests unusual payment arrangements (e.g., payments to unrelated third parties, cash only payments, splitting payments between multiple accounts).
6. Investor insists on liquidating its entire investment for unusual or unreasonable reasons/ circumstances without regard for substantial losses.
7. Investor provides funds solely via cash payments, which should always be rejected.
8. Investor requests that transactions be processed in a manner that would avoid the Private Fund's documentation procedures.

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[10] Pursuant to OFAC's 50% Rule, OFAC will deem an entity that is not otherwise the subject of sanctions to be a sanctioned party if SDNs have a 50% or more ownership in the aggregate of the entity. We recommend contacting outside counsel in these situations to strategize an appropriate response.

9. Investor requests economically irrational transfers, e.g., substantial investments that are followed up with redemption requests outside of the normal period with no concern for the penalty incurred and no legitimate explanation for the request.

Any transaction should be considered a red flag if it has no business or apparent lawful purpose or is not the type of transaction in which an investor would normally be expected to engage. Advisers should examine the available facts of the specific red flag and request further information from the investor, if necessary, to ascertain its purpose and mitigate the perceived AML risk and to assess potential reporting obligations.

C. Conclusion

Red flags can occur at any stage of the investor relationship and may be discovered at onboarding or through continuous transaction monitoring in connection with an AML compliance program.

Advisers and Private Funds should be attentive to potential changes in the law that may affect their AML compliance program, including FinCEN updates pursuant to the Anti-Money Laundering Act of 2020. As set forth in Lowenstein Sandler's previous client alert, "AML Best Practices for Private Fund Manager: The Prudence of Establishing an AML Compliance Program," an Adviser's and Private Fund's ongoing relationship with financial institutions is contingent on the Adviser's risk-based compliance with AML industry standards.

As always, Lowenstein Sandler LLP is available to assist with your AML compliance needs. For any questions on AML or this article, please contact the authors of this article at LSAMLTeam@lowenstein.com.

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