

MEMO# 14707

May 7, 2002

TREASURY RELEASES INTERIM FINAL RULES ON MUTUAL FUND ANTI-MONEY LAUNDERING PROGRAMS

[14707] May 7, 2002 TO: TRANSFER AGENT ADVISORY COMMITTEE No. 39-02 RE: TREASURY RELEASES INTERIM FINAL RULES ON MUTUAL FUND ANTI-MONEY LAUNDERING PROGRAMS; SEC APPROVES NASD RULE ON BROKER-DEALER ANTI-MONEY LAUNDERING PROGRAMS The USA PATRIOT Act requires financial institutions, including broker-dealers and investment companies, to establish anti-money laundering (AML) compliance programs by April 24, 2002. Section 352 of the USA PATRIOT Act provides that these programs must include, at a minimum: (1) the development of internal policies, procedures, and controls; (2) the designation of a compliance officer; (3) an ongoing employee training program; and (4) an independent audit function to test programs. There were two important developments relating to AML compliance programs earlier this week. The Department of the Treasury's Financial Crimes Enforcement Network (FinCEN) released an interim final rule prescribing minimum standards for AML programs at open-end investment companies.¹ Separately, the Securities and Exchange Commission approved a National Association of Securities Dealers rule governing AML programs for NASD members, including mutual fund underwriters.² Both rules are briefly summarized below and copies of the releases are attached. FINCEN MUTUAL FUND AML PROGRAM RULE FinCEN's interim final rule requires that, by July 24, 2002 (ninety days after the effective date of the rule), "mutual funds develop and implement an anti-money laundering program reasonably designed to prevent them from being used to launder money or finance terrorist activities, which includes achieving and monitoring compliance with the applicable requirements of the BSA and Treasury's implementing regulations." ¹ See Financial Crimes Enforcement Network, "Anti-Money Laundering Programs for Mutual Funds" (the "FinCEN Release"), available at <http://www.treas.gov/press/releases/352regmufund.pdf>. The FinCEN Release should be published in the Federal Register shortly. Treasury will accept comments for thirty days after publication of the rule in the Federal Register. ² See Securities Exchange Act Release No. 45798 (April 22, 2002) (the "NASD Release") (approving NASD Regulation Rule 3011, which requires NASD's member firms to develop, and a member of the firm's senior management to approve, programs designed to achieve and monitor compliance with the BSA and related regulations). ² The rule applies only to mutual funds (those investment companies falling within the category of "open-end company" contained in section 5(a)(1) of the Investment Company Act of 1940). Closed-end funds, unit investment trusts, and other types of entities that might be considered "investment companies" for purposes of the Bank Secrecy Act (BSA) were excluded from the current application of this rule. In large part, the interim final rule merely restates the minimum standards prescribed

in the USA PATRIOT Act and noted above. However, the rule and the FinCEN Release contain several notable points: Board Approval. Section 103.130(b) of the rule requires the fund's AML program to be approved in writing by the fund's board of directors or trustees. The FinCEN Release explains that this requirement is designed "to assure that [the AML program] requirement receives the highest level of attention throughout the industry." However, the FinCEN Release notes that the board's approval could be given at its first regularly scheduled meeting after the program is adopted. Future BSA Responsibilities. The FinCEN Release notes that mutual funds will be required to comply with BSA requirements regarding account holder identification and verification pursuant to section 326 of the USA PATRIOT Act when such rules are adopted,³ and that mutual funds are likely to become subject to additional BSA requirements, including filing suspicious activity reports (SARs). The FinCEN Release further notes that as mutual funds become subject to additional requirements, their compliance programs will have to be updated to include appropriate policies, procedures, training, and testing functions. Delegation of Compliance Functions. The FinCEN Release takes note of the fact that mutual funds typically conduct their operations through separate entities, which may or may not be affiliated, and that some elements of the compliance program will best be performed by personnel of these separate entities. The FinCEN Release thus concludes that it is permissible for a mutual fund to contractually delegate the implementation and operation of its anti-money laundering program to another affiliated or unaffiliated service provider, such as a transfer agent. In order to do so, however, the FinCEN Release states that the mutual fund must, among other things, obtain written consent from the third party ensuring the ability of federal examiners to obtain information and records relating to the anti-money laundering program and to inspect the third party for purposes of the program. The FinCEN Release further states that it would not be sufficient for a fund to simply obtain a certification from its delegate that the delegate "has a satisfactory anti-money laundering program." Instead, the fund must take affirmative steps to assure compliance with the AML program rule by the delegate. Omnibus Accounts. The FinCEN Release states that "given Treasury's risk-based approach to anti-money laundering programs . . . , it is not expected that mutual funds will scrutinize activity in omnibus accounts to the same extent as individual accounts. Nevertheless, mutual funds would need to analyze the money laundering risks posed by particular omnibus accounts based upon a risk-based evaluation of relevant factors." ³ The USA PATRIOT Act requires joint Treasury/SEC regulations to take effect by October 26, 2002. ³ regarding the entity holding the omnibus account, including such factors as the type of entity, its location, type of regulation, and of course, the viability of its anti-money laundering program." Audit Requirement. The FinCEN Release states that the independent audit required by both the rule and the USA PATRIOT Act may be accomplished either by employees of the fund, its affiliates, or unaffiliated service providers so long as those same employees are not involved in the operation or oversight of the fund's AML program. The FinCEN Release further states that a written assessment or report should be a part of the audit review, and any recommendations resulting from such review should be promptly implemented or submitted to the fund's board for consideration. Neither the rule nor the FinCEN Release specify how frequently the audit must be conducted. However, the FinCEN Release notes that "the frequency of [the audit] would depend upon factors such as the size and complexity of the mutual fund complex and the extent to which its business model may be more subject to money laundering than other institutions." AML Compliance Officer. The FinCEN Release states that the function of the compliance officer required by the rule and the USA PATRIOT Act can be carried out either by an individual or a committee. It further states that, while in many cases the implementation and operation of the AML compliance program will be conducted by entities (and their employees) other than the mutual fund, the person responsible for the supervision of the overall program should be a

fund officer. Employee Training. The FinCEN Release notes that the required AML training could be conducted by outside or in-house seminars, and could include computer-based training. Voluntary Reporting. The FinCEN Release specifically encourages mutual funds to adopt procedures for voluntarily filing suspicious activity reports (SARs) with FinCEN and to report suspected terrorist activities to FinCEN using its Financial Institutions Hotline (1-866-566-3974). THE NASD BROKER-DEALER AML PROGRAM RULE On February 15, 2002, the NASD proposed Conduct Rule 3011 prescribing minimum standards for anti-money laundering compliance programs established by NASD members. On April 22, 2002, the SEC approved this new rule. As with FinCEN's rule for mutual fund AML programs, the NASD rule largely restates the minimum standards prescribed in the USA PATRIOT Act. It requires each NASD member, on or before April 24, 2002, to develop and implement a written anti-money laundering program reasonably designed to achieve and monitor the member's compliance with the requirements of the BSA and the regulations thereunder. The program must be approved in writing by a member of senior management. The Institute commented on the NASD's rule proposal, recommending that the rule provide an exemption for broker-dealers who underwrite securities issued by funds that have established an anti-money laundering program meeting the requirements of Section 352 of the Act (and any rule applicable to funds adopted thereunder). The exemption proposed by the 4 Institute would have applied only with respect to the broker-dealer's fund underwriting activities. The NASD declined to create such an exemption in the final rule. However, the NASD Release suggests that anti-money laundering programs at broker-dealers that have no customers and handle no funds should be tailored to focus on "potential employee misconduct and counterparty awareness." The NASD Release reiterates that all broker-dealers are required to enact appropriate compliance procedures, but adds that in establishing such programs, broker-dealers may coordinate their efforts by taking account of programs and procedures of other firms with which they do business. The NASD Release suggests that principal underwriters to mutual funds would be expected to have similarly targeted procedures once the firms had assured themselves that the investment adviser or transfer agent within the fund complex had established and implemented a sufficient anti-money laundering program. The NASD Release notes, however, that no broker-dealer may rely solely on a program implemented by a firm with which it does business or has a business relationship.

EFFECTIVE AND COMPLIANCE DATES Both FinCEN's rule for mutual funds and NASD's rule for broker-dealers take effect on April 24, 2002. Compliance with the FinCEN rule is not mandatory until July 24, 2002 (ninety days after the effective date). It should be noted however, that the NASD rule does not have a similar grace period. Compliance with the NASD rule is required as of the effective date. Robert C. Grohowski Associate Counsel Attachment (in .pdf format)

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