

MEMO# 20009

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Treasury Adopts Suspicious Activity Reporting (SAR) Rule for Mutual Funds

©2006 Investment Company Institute. All rights reserved. Information may be abridged and therefore incomplete. Communications from the Institute do not constitute, and should not be considered a substitute for, legal advice. [20009] May 4, 2006 TO: AML COMPLIANCE WORKING GROUP No. 14-06 COMPLIANCE MEMBERS No. 23-06 OPERATIONS MEMBERS No. 11-06 SEC RULES MEMBERS No. 44-06 SMALL FUNDS MEMBERS No. 39-06 TRANSFER AGENT ADVISORY COMMITTEE No. 31-06 RE: TREASURY ADOPTS SUSPICIOUS ACTIVITY REPORTING (SAR) RULE FOR MUTUAL FUNDS The Department of the Treasury's Financial Crimes Enforcement Network (FinCEN) has adopted a rule that will require mutual funds to report suspicious transactions.¹ The new rule, which has a 180-day implantation period, will apply to transactions occurring after October 31, 2006. The major provisions of the rule are briefly summarized below. The Standard for Reportable Transactions The rule requires mutual funds² to report any suspicious transaction relevant to a possible violation of law or regulation. A transaction is reportable if: 1. It is conducted or attempted by, at, or through a mutual fund; 2. It involves or aggregates funds or other assets of at least \$5,000; and 1 Financial Crimes Enforcement Network; Amendment to the Bank Secrecy Act Regulations – Requirement that Mutual Funds Report Suspicious Transactions, 71 Fed. Reg. 26213 (May 4, 2006) (the "Release"). The final rule is also available on FinCEN's web site at http://www.fincen.gov/mutual_fund_sar_final.pdf. 2 The rule defines mutual funds as open-end investment companies registered or required to be registered with the Securities and Exchange Commission under the Investment Company Act of 1940. 2 3. The mutual fund knows, suspects, or has reason to suspect that the transaction (or a pattern of transactions of which the transaction is a part): a. Involves funds derived from illegal activity or is intended or conducted in order to hide or disguise funds or assets derived from illegal activity as part of a plan to violate or evade any federal law or regulation or to avoid any transaction reporting requirement under federal law or regulation; b. Is designed, whether through structuring or other means, to evade the requirements of the Bank Secrecy Act; c. Has no business or apparent lawful purpose or is not the sort in which the particular customer would normally be expected to engage, and the mutual fund knows of no reasonable explanation for the transaction after examining the available facts, including the background and possible purpose of the transaction; or d. Involves use of the mutual fund to facilitate criminal activity. The Release states that a mutual fund must base its determination as to whether a report is required on all the facts and circumstances relating to the transaction and the customer of the mutual fund in question. The Release notes that the rule is not intended to operate in a mechanical fashion, and thus, for example, transactions involving investments by the pension fund of a publicly traded corporation, even though involving a large dollar amount, would likely require a more limited scrutiny than less typical transactions such as those involving customers who wish to use currency

or money orders to purchase mutual fund shares, even though the dollar amounts in those latter cases may be relatively small.³ The Release includes two important clarifications relating to a mutual fund's reporting obligations. First, in response to the Institute's concern that a mutual fund might be expected to obtain additional information that it does not already have to meet the standard for reportable transactions, the Release states that funds are expected to determine whether to file a SAR "based on the information obtained in the account opening process or subsequently in the course of processing transactions."⁴ Second, the Release specifically addresses omnibus accounts by stating: In the case of a transaction conducted through an omnibus account maintained by an intermediary, a mutual fund may not know, suspect, or have reason to suspect that the transaction is one for which reporting would be required, because a fund typically has little or no information about individual customers of the intermediary. An omnibus account is 3 Release, at n.24. 4 Release, at n.29. 3 usually maintained by another financial institution, such as a broker-dealer, that has a reporting obligation with regard to its customers. The omnibus account holder (i.e., the financial institution intermediary) is a customer of the mutual fund for purposes of the final rule.⁵ The Filing of SARs Mutual funds are required to report suspicious transactions on Form SAR-SF, the same form used by broker-dealers. Reports must be made within 30 days after the mutual fund becomes aware of a suspicious transaction. The rule allows funds that do not identify a suspect on the date of the initial detection to delay filing for an additional 30 days. Mutual funds must retain any filed SAR-SFs and any supporting documentation for five years. The rule permits a single report - referred to as a "joint filing" - to satisfy the reporting obligations of all of the mutual funds, service providers, and other financial institutions involved in a particular transaction, as long as the report contains all of the relevant facts and each mutual fund maintains a copy of the joint filing along with any supporting documentation. Importantly, the Release recognizes that, in order to make a joint filing, mutual funds, service providers, and other financial institutions typically will exchange information and clarifies that they can do so without violating the non-disclosure provisions of the final rule (which are described below). In this regard, the Release states: Prior to filing a joint report, a mutual fund may share information pertaining to a suspicious transaction with any other financial institution or service provider involved in the transaction, provided that such financial institution or service provider will not be the subject of the report. Such sharing of information does not violate the non-disclosure provisions of section 103.15(d). If a service provider is performing the reporting obligations of one or more mutual funds under contract with the fund(s), the service provider may similarly share the information as an agent of the mutual fund(s). However, after the report is filed, further disclosure of the fact that a suspicious activity report was filed is prohibited, except as permitted by section 103.15(d).⁶ The Release states that it is permissible for a mutual fund to contractually delegate performance of the reporting obligation to an affiliated or unaffiliated service provider, such as a transfer agent. It also states, however, that in such a case the fund remains responsible for assuring compliance with the rule and must actively monitor the service provider's procedures for reporting suspicious transactions. 5 Release, at n.26. 6 Release, at 26217 (footnotes omitted). 4 In this regard, the Release states that funds "steps to assure that the service provider has implemented effective compliance policies and procedures administered by competent personnel, and should maintain an active working relationship with the service provider's compliance personnel."⁷ Non-Disclosure Provisions Consistent with the SAR rules for broker-dealers and banks, the rule prohibits mutual funds filing SAR-SFs from making any disclosure, except to law enforcement and regulatory agencies, about either the reports themselves or supporting documentation. Safe Harbor Like the bank and broker-dealer SAR rules, the rule includes a safe harbor that protects any mutual fund and any director, trustee, officer, employee or agent of a mutual fund from civil liability for reporting suspicious activity.

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