

MEMO# 14948

July 23, 2002

TREASURY AND SEC PROPOSE CUSTOMER IDENTIFICATION PROGRAM RULE

[14948] July 23, 2002 TO: BROKER/DEALER ADVISORY COMMITTEE No. 22-02 COMPLIANCE ADVISORY COMMITTEE No. 52-02 SEC RULES MEMBERS No. 53-02 SMALL FUNDS MEMBERS No. 22-02 RE: TREASURY AND SEC PROPOSE CUSTOMER IDENTIFICATION PROGRAM RULE

The Department of the Treasury's Financial Crimes Enforcement Network (FinCEN) and the Securities and Exchange Commission have jointly proposed a rule on customer identification programs (CIPs) for mutual funds.¹ This rule would implement Section 326 of the USA PATRIOT Act. The proposed rule is briefly summarized below, and a copy of the Release is attached. Scope of the Proposed Rule The proposed rule would apply to all mutual funds – i.e., those entities required to register with the SEC as investment companies and that fall within the category of “open-end company” contained in section 5(a)(1) of the Investment Company Act of 1940. The proposed rule would not apply to other types of investment companies, such as closed-end funds and unit investment trusts.² Parallel regulations governing CIPs for broker-dealers and banking institutions are being issued separately. Two definitions are central to determining the scope of the rule. First, the proposed rule defines “account” to mean “any contractual or other business relationship between a customer and a mutual fund established to effect financial transactions in securities, including the purchase or sale of securities.” The Release explains that this definition is intended to include all types of securities accounts maintained by mutual funds. Second, the proposed rule defines “customer” to include (1) any mutual fund shareholder of record who opens a new account with a mutual fund and (2) any person 1 See Financial Crimes Enforcement Network; Securities and Exchange Commission, Joint Notice of Proposed Rulemaking, “Customer Identification Programs for Mutual Funds,” 67 Fed. Reg. 48318 (July 23, 2002) (the “Release”). 2 The Release indicates, however, that Treasury and the SEC will continue to consider whether a CIP requirement would be appropriate for the issuers of these products, or whether they are effectively covered by the CIP requirements of other financial institutions involved in their distribution (e.g., broker-dealers). 2 authorized to effect transactions in the shareholder of record's account with a mutual fund. The rule does not apply to persons merely seeking information about a mutual fund prospectus or profile, nor does it apply to accounts opened due to transfers not initiated by a customer (e.g., as a result of a merger, acquisition, or purchase of assets). CIPs and CIP Procedures General Requirement. The proposed rule would require all mutual funds, as part of their AML programs, to establish, document and maintain a written CIP that enables the mutual fund to form a reasonable belief that it knows the true identity of its customers. Under the proposed rule, the CIP would have to be approved by the fund's board of directors or trustees. The proposed rule would require a mutual fund's CIP

procedures to be based on the type of identifying information available to it and on an assessment of relevant risk factors including: (1) the mutual fund's size; (2) the manner in which accounts are opened, fund shares are distributed, and purchases, sales and exchanges are effected; (3) the mutual fund's types of accounts; and (4) the mutual fund's customer base.

Identifying Information. The proposed rule would require mutual funds to obtain each customer's name, date of birth (for a natural person), addresses (both residence/principal place of business and a mailing address, if different), and an identification number. With respect to this last item, the proposed rule would require a taxpayer identification number for each U.S. customer. Each non-U.S. customer would be required to provide a taxpayer identification number, passport number and country of issuance, alien identification card number, or number and country of issuance of any other government-issued document evidencing nationality or residence and bearing a photograph or similar safeguard. The Release indicates that the proposed rule merely sets forth the minimum required information, and that mutual funds may, at times, need to consider whether to obtain additional information.

3 Verification. The proposed rule would require the CIP to include procedures for verifying the identity of customers to the extent reasonable and practicable. Verification can occur within a reasonable time before or after the customer's account is opened or the customer is granted authority to effect transactions with respect to an account. The proposed rule provides for verification through documents and/or through non-documentary methods, and requires CIP procedures to address both methods and describe when each would be employed.

4 3 According to the Release: The rule only specifies the minimum identifying information that must be obtained from each customer. Mutual funds, in assessing the risk factors in paragraph (b), should determine whether obtaining other identifying information is necessary to form a reasonable belief as to the true identity of each customer. There may be circumstances when a mutual fund should obtain additional identifying information. The CIP should set forth guidelines regarding what those circumstances are and what additional information should be obtained in such circumstances.

Release at 14. 4 In fact, the Release indicates that, in light of the recent increase in identity fraud, mutual funds are encouraged to use non-documentary methods even when a customer has provided identification documents. **3** It also specifies certain circumstances in which non-documentary methods must be used. Examples of each method are included in the proposed rule. The CIP would be required to specify actions to be taken if the fund cannot form a reasonable belief that it knows the true identity of a customer, which could include closing the account or placing limitations on additional purchases. The Release indicates that the CIP also should include guidelines for when an account will not be opened (e.g., when the required information is not provided), and that it should address the terms under which a customer may conduct transactions while the customer's identity is being verified. The Release states that a mutual fund's CIP does not have to include verification of the identities of individuals whose transactions are conducted through an omnibus account, and that the proposed rule does not require that a mutual fund obtain any additional information regarding the identities of individual shareholders who open their accounts through an omnibus accountholder. The Release notes, however, that the omnibus account holder is itself a customer for purposes of the proposed rule.

Government Sponsored Lists. The proposed rule would require CIPs to include procedures for determining whether a customer's name appears on any list of known or suspected terrorists or terrorist organizations prepared by any federal government agency and made available to the mutual fund.

Notice. The proposed rule would require mutual funds to provide customers with adequate notice that the mutual fund is requesting information to verify the customer's identity.

Recordkeeping. The proposed rule would require CIPs to include procedures for maintaining a record of all information obtained pursuant to the CIP. These records would have to be retained for five

years after the date the account of the customer is closed. The Release states that nothing in the proposed rule modifies, limits or supersedes the Electronic Records in Global and National Commerce Act (E-Sign), and thus a mutual fund may use electronic records to satisfy the recordkeeping requirements of the proposed rule. Exemptive Authority The proposed rule allows the SEC, with the concurrence of the Secretary of the Treasury, to exempt any mutual fund or type of account from the requirements of the proposed rule by order or regulation. Delegation of CIP Compliance The Release notes that mutual funds typically conduct their operations through separate entities, and that some of the elements of the CIP will best be performed by personnel of these separate entities. Accordingly, the Release states that it is permissible a mutual fund to contractually delegate the implementation and operation of its CIP to another affiliated or unaffiliated service provider, such as a transfer agent. In any event, since the mutual fund remains responsible for assuring compliance with the rule, it must actively monitor the operation of its CIP and assess its effectiveness. 4 Specific Requests for Comments FinCEN and the SEC have requested comment on all aspects of the proposed rule. However, they specifically request comment on the following issues: 1. Whether the proposed definition of "account" is appropriate and whether other examples of accounts should be added to the regulatory text; 2. How mutual funds can comply with the requirement to obtain both the address of a person's residence, and, if different, the person's mailing address in situations involving natural persons who lack a permanent address; 3. Whether non-U.S. persons that are not natural persons will be able to provide a mutual fund with the required identifying information, or whether other categories of identifying information should be added; and 4. The extent to which the verification procedures required by the proposed regulation will use information that mutual funds currently obtain in the account opening process. Comments are due on September 6, 2002. The Institute is working with its Money Laundering Rules Working Group and Transfer Agent Advisory Committee in developing comments on this proposal. If you would like to participate in the working group, please contact Amanda Busick at 202-326-5836 or abusick@ici.org. Robert C. Grohowski Associate Counsel

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