The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

COMMENT LETTER

November 22, 2002

Comment Letter on Anti-Money Laundering Programs for Unregistered Funds, November 2002

November 22, 2002

Judith R. Starr, Chief Counsel
Office of the Chief Counsel
Financial Crimes Enforcement Network
Department of the Treasury
P.O. Box 39
Vienna, Virginia 22183-1618

Re: NPRM – Section 352 Unregistered Investment Company Regulations

Dear Ms. Starr:

The Investment Company Institute 1 appreciates the opportunity to comment on the recently proposed rule relating to anti-money laundering programs for unregistered investment companies (the "Proposed Rule").2 The Proposed Rule would implement Section 356 of the USA PATRIOT Act (the "Act")3 by requiring that all unregistered investment companies (as defined in the Proposed Rule) adopt and implement anti-money laundering programs.

The Institute strongly supports effective rules to combat potential money laundering activity in the financial services industry and, in general, supports the rule as drafted. However, we have two recommended changes. First, we are concerned that the Proposed Rule may impose unnecessary, duplicative and inconsistent obligations on offshore publicly sold funds that are subject to strong anti-money laundering regimes outside the United States. Accordingly, we recommend that an exception be added to the final rule that would cover these funds. Second, we are concerned that the Proposed Rule may extend to funds without an appropriate nexus to the United States. Accordingly, we recommend changes to the definition of "unregistered investment company" in the Proposed Rule that would limit the scope of the rule to funds with U.S. investors.

1. The Application of the Rule to Offshore Retail Funds

The Proposed Rule would require that all investment companies that are not registered under U.S. law adopt anti-money laundering programs. Section 103.132(a)(6) of the

Proposed Rule defines the term “unregistered investment company” to include any issuer that is a company that meets four criteria:

- The issuer: (1) would be an investment company under the 1940 Act but for the exclusions provided for in Sections 3(c)(1) and 3(c)(7) of the 1940 Act; (2) is a commodity pool; or (3) invests primarily in real estate and/or interests therein;
- The issuer permits an owner to redeem his or her ownership interest within two years of the purchase of that interest;
- The issuer has total assets (including received subscriptions to invest) as of the end of the most recently completed calendar quarter the value of which is $1,000,000 or more; and
- The issuer is organized under the law of a State or the United States, is organized, operated or sponsored by a U.S. person, or sells ownership interests to a U.S. person.4

We believe that the jurisdictional reach of this last provision, Section 103.132(a)(6)(i)(D) of the Proposed Rule, is overly broad. It would extend this rule to every fund in the world that has a U.S. sponsor or even a single U.S. investor (assuming that such funds meet the other elements of the definition). The nexus of sales to U.S. investors can be particularly tenuous in some cases. Foreign funds sponsored by U.S. fund management companies often will have a U.S. shareholder solely by virtue of the sponsor’s seed money investment. In addition, funds sponsored by foreign management companies could be deemed to sell shares to a person in the U.S. by reinvesting dividends for an existing shareholder who has moved to the U.S. In either case, the offshore fund would have a U.S. investor without ever having marketed its shares in the U.S.

As the purpose of the rule is to impose AML obligations on unregistered investment companies, we question whether the language in the rule is intended to, or should, cover a fund that is domiciled outside the U.S. and registered or authorized under the law of that jurisdiction for public sale to non-U.S. persons, particularly if it is subject to stringent AML requirements. We do not believe that such a fund should come within the rule merely because it is sponsored by U.S. fund management companies or because it has a single U.S. shareholder. In the realm of publicly registered and sold funds, we believe that the controlling principle should be whether the fund is subject to an adequate anti-money laundering regime.5 Such a regime could be imposed by the country of domicile, or by the country in which fund administration actually takes place.

We therefore strongly recommend that an exception be added to Section 103.132(a)(6)(ii) to cover any investment company that is (i) registered or authorized for public sale and (ii) domiciled or functionally administered in an FATF-GAFI member country, such that the fund is subject to the anti-money laundering requirements in that country.6 Given the stringent anti-money laundering regimes in these jurisdictions, we believe that such funds pose little threat of money laundering. In addition, compliance with two comprehensive anti-money laundering regimes (the U.S. and the FATF-GAFI member country) could prove to be difficult, since there may be certain elements of the regimes that are in conflict. For example, it is our understanding that laws in some foreign jurisdictions may prohibit local transfer agents from agreeing to an inspection by U.S. regulators. This would effectively make delegation under the rule to these transfer agents impossible.7 Since, in many circumstances, the transfer agent is the only entity that can effectively implement certain elements of AML compliance, this inability to delegate will make it extremely difficult for funds that use transfer agents from these jurisdictions to comply with the rule.

2. Recommended Changes to the Definition of "Unregistered Investment Company"

In addition, even if the change we recommend above is made, we believe that Section 103.132(a)(6)(i)(A)(1) of the Proposed Rule may be too broad. This section would cover any issuer that "would be an investment company" under the 1940 Act, but for the exceptions in Sections 3(c)(1) and 3(c)(7) of the 1940 Act. These exceptions allow funds to make certain limited private offerings of their shares to U.S. investors without having to register as investment companies.

The practical application of this definition is unclear, since the 1940 Act's definition of investment company is not limited to funds that offer interests to U.S. investors.[8] As a result, the definition could be read to include a foreign fund that made no offers to U.S. investors and had no U.S. shareholders if a U.S. person provided investment advice or administrative services to the fund. (For example, because such a fund would have no U.S. shareholders, it would satisfy the condition in Section 3(c)(1) that the fund have fewer than 100 U.S. shareholders.)

We recommend that this Section be clarified to limit its scope to those funds that actually rely on Sections 3(c)(1) and 3(c)(7) of the 1940 Act to avoid registration as an investment company in the United States. Specifically, we suggest that the Section be revised as follows:

(1) Would be required to register as an investment company under section 8 of the Investment Company Act of 1940 (15 U.S.C. 80a) or obtain an order from the Securities and Exchange Commission under section 7(d) of that Act (17 U.S.C. 80a-7(d)) but for the exclusions provided for in sections 3(c)(1) and 3(c)(7) of that Act (17 U.S.C. 80a-3(c)(1) and (7));

We believe that this change would be consistent with FinCEN's intended application of the rule. The Release explains that the Proposed Rule's jurisdictional limitation was necessary because "many of these unregistered investment companies operate 'offshore' and offer interests in their companies to both U.S. and foreign investors."[9] The change that we propose would clarify that offshore funds that are sold entirely to non-U.S. investors would not be covered by the rule.[10]

We believe that this change would establish the appropriate nexus for applying the AML rules to unregistered investment companies and that, under the approach we recommend, other jurisdictional elements of Section 103.132(a)(6)(i)(D) of the Proposed Rule would become unnecessary and should be deleted.[11]

* * *

Thank you for considering our comments on the Proposed Rule. If you have any questions or need additional information, please contact me at (202) 326-5815, Mary Podesta at (202) 326-5826 or Bob Grohowski at (202) 371-5430.

Sincerely,

Craig S. Tyle
General Counsel

cc: Paul F. Roye
Director, Division of Investment Management
Securities and Exchange Commission

ENDNOTES

1 The Investment Company Institute is the national association of the American investment company industry. Its membership includes 8,949 open-end investment companies ("mutual funds"), 527 closed-end investment companies, and six sponsors of unit investment trusts. Its mutual fund members have assets of about $6.045 trillion, accounting for approximately 95 percent of total industry assets, and over 90.2 million individual shareholders.

2 See Financial Crimes Enforcement Network; "Anti-Money Laundering Programs for Unregistered Investment Companies," 67 Fed. Reg. 60617 (September 26, 2002) (the "Release").

3 Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001, Pub. Law No. 107-56 (October 26, 2001).

4 For purposes of this paragraph (a)(6)(i)(D), the term U.S. Person has the same meaning as provided in 17 CFR 230.902(k)).

5 This principle should apply to U.S. mutual funds as well, since they are subject to the Act's anti-money laundering regime. In our view, a U.S. mutual fund that happens to have a few foreign shareholders should not be subject to the anti-money laundering regime in the foreign jurisdiction in addition to the anti-money laundering regime impo sed under the Act.

6 A list of the 31 FATF-GAFI member countries can be found at http://www.fatf-gafi.org/Members_en.htm.

7 The Release states that "any unregistered investment company that delegates responsibility for aspects of its anti-money laundering program to a third party [must ensure] that federal examiners are able to obtain information and records relating to the anti-money laundering program and to inspect the third party for purposes of the program." Release, 67 Fed. Reg. at 60621.

8 Section 3 of the 1940 Act, which defines the term "investment company", applies to any issuer that meets the substantive terms of the definition. See Section 3(a)(1) of the 1940 Act.

9 Release, 67 Fed. Reg. at 60619.

10 Any investment company that offered its interests to U.S. investors would be in violation of Section 7 of the 1940 Act unless it either registered as an investment company under Section 8 of the 1940 Act (if the fund was organized in the U.S.) or obtained an order from the Securities and Exchange Commission under Section 7(d) of the 1940 Act (if the fund was organized outside the U.S.). Funds relying on Sections 3(c)(1) or 3(c)(7) are, by definition, not investment companies under the 1940 Act, and thus not required to register or obtain such an order. Funds that sell interests to both U.S. and non-U.S. investors may rely on Sections 3(c)(1) or 3(c)(7). See Touche Remnant & Co., SEC No-Action Letter, [1984-85 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,810 (Aug. 30, 1984). Funds that do not offer interests to U.S. investors do not need to rely on the exceptions in Sections 3(c)(1)

or 3(c)(7), since they never trigger the registration or order provisions in Section 7 of the 1940 Act.

11 One effect of this change would be to clarify that a fund with no U.S. investors would not be subject to the rule, even if it was organized, operated or sponsored by a U.S. person. We believe this is entirely appropriate. Investment company AML program rules, whether covering mutual funds or unregistered investment companies, should be limited to those investment companies that have U.S. investors. If Treasury wishes to extend AML rules to U.S. entities organizing, operating or sponsoring investment companies, it should do so through a rule specifically designed for U.S. entities that sponsor funds. Indeed, it is our understanding that Treasury is considering a rule that would require all U.S. investment advisers to adopt anti-money laundering programs. Such a rule could be used for this purpose.
