The Asset Management Industry
SERVING INDIVIDUAL INVESTORS

INVESTMENT COMPANY INSTITUTE

COMMENT LETTER

September 6, 2002

Comment Letter on Anti-Money Laundering Rules and Transition Period, September 2002

September 6, 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

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-0609

Re: Section 326 Mutual Fund Rule Comments

Dear Ms. Starr and Mr. Katz:

The Investment Company Institute[1] appreciates the opportunity to comment on the recently proposed rule relating to customer identification programs ("CIPs") for mutual funds (the "Proposed Rule").[2] The Proposed Rule would implement Section 326 of the USA PATRIOT Act (the "Act")[3] by requiring that all mutual funds adopt and implement reasonable procedures to verify the identity of any person seeking to open an account, maintain records of information used to verify the person's identity, and determine whether the person appears on any lists of known or suspected terrorists or terrorist organizations.

The Institute strongly supports effective rules to combat potential money laundering activity in the investment company industry and, in general, supports the Proposed Rule as drafted. However, we have a number of specific comments, set forth below, that address: the definition of customer; intermediated accounts; the recordkeeping requirements; the

role of mutual fund boards; and the requirement to search government lists of known or suspected terrorists. In addition to these specific comments, we urge Treasury to consider appropriate implementation and transition periods for this rule, in order to accommodate the significant systems and other changes that will have to be made to comply with its requirements.

I. Specific Comments and Recommendations

1. Definition of "Customer"

a. Individuals with Authority to Effect Transactions

The proposed rule defines "customer" as any shareholder of record who opens a new account with a mutual fund and any person granted authority to effect transactions in the shareholder of record's account with a mutual fund.4 We believe that the inclusion of all persons with the authority to effect transactions makes the definition unintentionally broad. Moreover, we are concerned that it would adversely affect fund investors and impose substantial burdens on funds in a variety of circumstances, many of which do not raise money laundering concerns. Therefore, as discussed further below, we strongly recommend that the definition of customer be limited to shareholders of record who open new accounts and individuals who open new accounts on behalf of or for the benefit of shareholders of record.

The following examples illustrate the breadth of the definition of customer as proposed and the effects on shareholders and funds that we believe are unintentional. First, a mutual fund shareholder's broker often will have the authority to effect transactions in the shareholder's account. Under a strict reading of the Proposed Rule, the individual broker would be a customer of the fund. This would require the individual broker to divulge his or her personal information (i.e., name, address, date of birth, and social security number) to every mutual fund in which any of his or her customers invest, and would require the fund take reasonable steps to verify his or her identity. We believe that this would be an unwarranted intrusion on the broker's privacy and is unnecessary to prevent money laundering.

Second, it is common for 401(k) plans and other defined contribution plans to allow participants to direct their account investments among a number of investment options, including mutual funds, offered by the plan. In such cases, plan sponsors often will direct financial institutions providing plan services to accept instructions from participants. Congress clearly expressed its intent regarding this and other situations involving retirement plan investments in mutual funds: "Where a mutual fund sells its shares to a qualified retirement plan, the plan, and not its participants, would be the fund's customers. Thus, the fund should not be required to 'look through' the plan to identify its participants."5 Nevertheless, under a strict reading of the Proposed Rule, it is unclear whether these retirement plan participants could be deemed customers of the fund, and thus subject to identification and verification requirements.

Third, the proposed definition appears to capture a number of other persons who pose little or no money laundering risk, such as court-appointed executors and guardians and individuals who are granted authority to effect transactions in an account upon the death of a shareholder, such as Individual Retirement Account (IRA) beneficiaries.

Fourth, the proposed definition of "customer" would include any individual acting on behalf

of an entity, such as a corporation or retirement plan, to effect transactions in the entity's account. Given that a substantial number of individuals often are granted authority to effect transactions in these types of accounts, and that these individuals often change over time, we believe that treating all of these individuals as customers under the CIP rule would lead to a significant number of delays in effecting transactions in these accounts. Moreover, we question whether the treatment of these individuals as customers is necessary to address money laundering concerns. Administrative personnel and other individuals acting on behalf of publicly traded corporations or retirement plans, for example, pose a minimal risk of money laundering. Moreover, mutual funds have procedures to authenticate an individual's authority to act on behalf of an entity before permitting that individual to redeem shares owned by the entity. Obtaining additional pieces of information, such as the individual's date of birth, would not seem to further anti-money laundering purposes.

Limiting the definition of "customer" to shareholders of record and other individuals who open new accounts would alleviate many of our concerns about the breadth of the definition as proposed.6 At the same time, it would address customer identification and verification in a way that is consistent with both the express language of Section 326 and sound anti-money laundering policies. Section 326 states that "the Secretary of the Treasury shall prescribe regulations setting forth the minimum standards for financial institutions and their customers regarding the identity of the customer that shall apply in connection with the opening of an account at a financial institution."7 By focusing on the identification and verification of individuals and entities involved in the opening of an account, Section 326 recognizes and seeks to address concerns with illegitimate investors and persons who might seek to use legitimate investors as a front for their own illegitimate purposes. Our proposed definition would subject both types of persons to identification and verification requirements.

To the extent that Treasury and the SEC do not implement our recommendation and instead retain the "authority to effect transactions" language in the definition, we strongly recommend that the definition of customer in the final rule exclude the five categories of individuals described above: (1) broker-dealer representatives; (2) defined contribution retirement plan participants; (3) court-appointed guardians and trustees; (4) individuals granted trading authority as a result of the death of a shareholder; and (5) individuals acting on behalf of entities (i.e., non-natural persons), other than those opening an account on behalf of the entity.8 In our view, the burdens associated with subjecting these individuals to identification and verification procedures are unnecessary to achieve the goals of Section 326.

b. Exchanges of Fund Shares

The Release states that "a shareholder who exchanges shares of one fund for shares of another fund within the same account (or initiates any other transaction that does not involve the opening of a separate account) does not become a 'customer' for the purpose of this rule."9 The Institute supports this position. We believe it correctly recognizes that a mutual fund shareholder's exchange transaction does not result in a new customer relationship and, more importantly, does not present any potential for money laundering since no assets are returned to the shareholder.10

As a technical matter, however, exchanges do not necessarily occur within a single mutual fund account. Instead, a shareholder may have an account (with a separate account number) for each fund in a fund family in which he or she invests. Thus, an exchange may be between two existing accounts, or may cause a new account to be opened. As proposed,

if a new account is opened, the shareholder would become a customer under the rule.

Given the statement in the Release about exchanges, we do not believe that this result was intentional. We therefore request that Treasury and the SEC clarify in the release adopting the final rule that exchanges of fund shares would not cause an existing fund shareholder to become a customer for purposes of the rule.

2. Intermediated Accounts

Many mutual fund accounts are opened by a broker-dealer or other intermediary that has identification and verification responsibilities under the Act. Where the intermediary holds an omnibus position in these accounts, the Release is clear that a mutual fund's CIP does not have to cover the intermediary's customers whose transactions are conducted through the omnibus account.[11] The Institute fully supports this treatment of omnibus accounts and account holders.

As the Institute noted in an earlier comment letter, there are other arrangements similar to omnibus accounts that we believe warrant similar treatment under fund AML programs.[12] These arrangements, which we referred to in our earlier letter as "intermediated accounts," include all accounts for which an intermediary required to have an AML program under Section 352 of the Act is involved in opening the account and maintains an ongoing client relationship with the shareholder. In some intermediated accounts, a mutual fund shareholder may be a "customer" (as defined in the Proposed Rule) of both the mutual fund and the intermediary. Consequently, the CIP rule as proposed could require both the fund and the intermediary to perform identification and verification on those shareholders.

The identification and verification of these customers by the mutual fund is unwarranted for several reasons. First, it would be duplicative. If the customer has been appropriately identified and verified once, there is no reason to have another financial institution repeat the same procedures.

Second, the identification and verification required by the rule may be difficult for the fund to complete in many of these cases. The intermediary will have all of the required customer identification information; the mutual fund (or its transfer agent) often will not. Obtaining the missing information likely would lead to a delay in opening the customer's account, since this information must be collected before an account is opened.[13] Customers would be exposed to market risk (i.e., the risk of being out of the market) during this delay. We believe that this exposure to market risk is an unnecessary burden on these shareholders. Moreover, requiring funds to collect this information does not seem to be consistent with the legislative intent behind Section 326. As quoted in the Release, the legislative history of Section 326 clearly indicates that Congress intended "the verification procedures prescribed by Treasury [to] make use of information currently obtained by most financial institutions in the account opening process."[14]

Third, reliance on an intermediary to perform the identification and verification would be entirely consistent with the risk-based approach generally taken in both the interim AML program rule[15] and the Proposed Rule.[16] Where an intermediary has an independent obligation to have a CIP that covers a mutual fund's shareholders, the fund should be able to reasonably rely on that intermediary to perform the identification and verification of those shareholders and focus its efforts on other, higher-risk customers.

For all of these reasons, we request that Treasury and the SEC confirm that in instances where another entity, such as a broker-dealer, has the obligation to perform identification

and verification, funds are not required to perform duplicative identification and verification on those customers. This could be accomplished either through an amendment to the Proposed Rule or a statement in the release accompanying the final rule.

3. Recordkeeping Requirements

The Proposed Rule would require mutual funds to retain three categories of CIP-related information: (1) all identifying information provided by a customer ("identification records"); (2) all records of the methods and results of measures undertaken to verify the identity of a customer ("verification records"); and (3) the resolution of any discrepancy in the identifying information obtained pursuant to the CIP.17 The Proposed Rule would require that all three categories of information be retained for five years after the date the customer's account is closed. We support the retention of identification records for five years after an account is closed, as proposed. However, we recommend changes to the rule with respect to the other two categories of information.

a. Verification Records

We believe that linking the retention of verification records to the date an account is closed will prove to be problematic. It is likely that verification procedures will be done through batch processing (i.e., the processing of all of the accounts opened during a particular time period) and exception reports. The rule as proposed would require each exception report to be retained for five years after the close of every account to which it relates. In practice, we believe that this would be highly impractical, if not impossible, to administer and would lead to the indefinite retention of these records. This would be burdensome and expensive, even if the records were maintained in electronic form.

More importantly, the indefinite retention of verification records does not seem necessary to achieve the legitimate policy goal of providing appropriate records to test for compliance with the CIP rule.18 Verification procedures could be tested by examining recent verification records; a complete history of exception reports does not seem necessary for this purpose.

Thus, we urge Treasury and the SEC to revise Section 103.131(h)(2) of the Proposed Rule to provide that verification records must be retained for five years from the date the verification is performed, rather than five years from the closing of the accounts to which those records relate. Such a requirement would be far easier to administer than the requirement in the Proposed Rule and entirely consistent with the purposes for which these records should be kept.

b. Resolution of Discrepancies

Section 103.131(h)(3) of the Proposed Rule would require that the resolution of any discrepancy in the identifying information obtained pursuant to the CIP be retained for five years after the account associated with the information is closed. Minor discrepancies, such as typographical errors, often arise and are resolved during the account opening process. These discrepancies would not seem to be of interest or value for anti-money laundering compliance purposes. We therefore recommend that the final rule incorporate a materiality standard into Section 103.131(h)(3), such that the records retained pursuant to the rule need only reflect the resolution of material discrepancies in the information obtained pursuant to a CIP.

4. Role of the Mutual Fund Board

The Proposed Rule would require that a mutual fund's board of directors or trustees approve the fund's CIP.[19] While the Institute questions the need for this requirement, we are even more concerned by the discussion of the board approval provision in the Release. After noting the approval requirement, the Release states that "[t]he board should periodically assess the effectiveness of its CIP and should receive periodic reports regarding the CIP from the person or persons responsible for monitoring the fund's anti-money laundering program pursuant to 31 CFR 103.30(c)(3)."[20] This statement is troublesome for the following reasons.

First and foremost, it appears to impose specific, ongoing responsibilities on fund boards with respect to mutual fund CIPs. In doing so, it fails to appreciate the appropriate role of fund boards. It is well-recognized that the intended role of fund directors is to serve as "watchdogs," protecting fund shareholders by policing potential conflicts between the interests of shareholders and those of fund management.[21] Having an effective CIP, while unquestionably important, does not raise any conflict of interest concerns. As such, the board's role in this context should be one of general oversight—the same as it is with respect to other compliance matters not involving potential conflicts of interest. Imposing more specific obligations on the board would contravene the SEC's efforts to allow fund directors "to focus to a greater extent on what they do best—exercising business judgment in their review of interested party transactions and in their oversight of operational matters where the interests of an investment company and its adviser may diverge."[22]

Second, none of the other releases proposing regulations to implement Section 326 includes a similar statement.[23] The Release does not provide a rationale for imposing specific, ongoing responsibilities on fund boards that do not appear to apply to the boards or similar bodies governing the other types of financial institutions as to which CIP implementing rules have been proposed to date.[24]

For both of these reasons, we recommend that the release accompanying the final CIP rule for mutual funds clarify that the rule does not impose specific, ongoing review and/or monitoring responsibilities on fund boards.

5. Requirement to Search Lists of Known or Suspected Terrorists

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. We agree with the Release insofar as it notes that mutual funds should already have procedures for checking customers against government lists, such as the Office of Foreign Assets Control (OFAC) lists. However, we are concerned that the breadth of the Proposed Rule—to check any list prepared by any federal government agency—could result in inadvertent violations of the rule.

We would encourage either Treasury or the SEC to act as a clearinghouse in this regard by formally (e.g., by rule or order) or informally (e.g., by posting on its web site) providing a catalog of the specific lists that mutual funds and other financial institutions are required to check, at least with respect to compliance with the CIP rule.[25] In our view, this would provide a level of certainty that would improve compliance and reduce associated costs.

II. Implementation and Transition Periods

Section 326 of the Act requires the CIP rule to take effect by October 25, 2002. However, implementation of the rule will involve several tasks that will take some time to accomplish. We therefore urge Treasury and the SEC to (1) allow funds a reasonable period of time to come into full compliance with the rule and (2) provide a reasonable transition period during which the identification of certain customers can be completed as soon as practicable after an account is opened.

1. Implementation Period

Implementation of the CIP rule will involve a number of steps. CIPs will have to be drafted, incorporated into AML programs and approved by fund boards. To open accounts, certain information will have to be obtained that may not currently be required, such as an identification number, residential address and date of birth. This will require account application forms to be revised and transfer agency systems to be reprogrammed for purposes of capturing the required information. Other systems changes will be necessary to facilitate and maintain records of verification procedures. Also, notice will have to be provided to customers, which will involve a further revision to the account application form or a revision to some other disclosure document.

Clearly, CIPs should be drafted and the changes to application forms and transfer agency systems should be made as soon as possible to help combat money laundering and terrorist financing. However, these tasks cannot effectively begin until after the rule is adopted. For example, until the required fields of information and the scope of the definition of customer (as discussed above) are known with certainty, application forms and transfer agency systems cannot be changed.

Once begun, it is our understanding that these systems and disclosure changes are likely to take at least six months to complete, and more likely nine months for many larger firms. We therefore urge Treasury and the SEC to set a compliance date at least six months after the rule is adopted in its final form. We view six months as the absolute minimum amount of time needed to come into compliance with the rule, and we strongly encourage Treasury and the SEC to consider a nine-month grace period to allow larger mutual fund complexes and transfer agents to make the necessary systems changes.

We note that in similar circumstances when rules have been issued near a statutory deadline, Treasury has been willing to extend the compliance date beyond the effective date in the statute.26 We urge Treasury and the SEC to take a similar approach here.

2. Transition Period

Even after CIPs have been drafted and approved, application forms have been changed, and transfer agency systems have been modified, a number of investors are likely to attempt to open accounts using old application forms. Mutual funds and their intermediaries certainly should be encouraged to use their best efforts to circulate new account application forms to all of their distribution channels. However, past experience with changes to application forms indicates that, despite these best efforts, investors are likely to attempt to open accounts using old application forms for more than a year.

To deal with the residual flow of old application forms, personnel involved in processing account applications will have to be trained to recognize and react to situations where a new investor or existing shareholder attempts to open an account using an old application

form. The investor will have to be contacted and provided with the required notice, any missing information will have to be collected, and verification will have to be performed. In the meantime, the transaction would likely be deemed not in good order and not processed. During this period, the investors would be exposed to market risk (i.e., the risk of being out of the market). We see this imposition of market risk as an unnecessary burden on investors who attempt to open legitimate accounts mistakenly using old application forms.

In order to better accommodate these investors, we recommend that the final rule provide a transition period during which the identification of certain customers can be done as soon as practicable after an account is opened. We recommend that this exception be limited to new accounts attempted to be opened using old application forms, and that it be further limited to those situations that do not raise heightened money laundering concerns. Thus, we would recommend that funds be encouraged to take a risk-based approach to the identification of these customers in these accounts during the transition period.

We believe that the residual flow of old application forms will largely dissipate within six months after new application forms are distributed. We therefore urge Treasury and the SEC to consider a transition period of six months after the date set for mandatory compliance, as discussed above.

* * *

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, Frances Stadler at (202) 326-5822 or Bob Grohowski at (202) 371-5430.

Sincerely,

Craig S. Tyle
General Counsel

Attachment

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 8,973 open-end investment companies (“mutual funds”), 514 closed-end investment companies and six sponsors of unit investment trusts. Its mutual fund members have assets of about $6.363 trillion, accounting for approximately 95 percent of total industry assets, and over 87.8 million individual shareholders.

2 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”).

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 Section 103.131(a)(3) of the Proposed Rule.

5 Release at n.14, quoting H.R. Rep. No. 107-250, pt. 1, at 62 (2001).

6 Our proposal would not address the potential application of the definition to a fund shareholder's broker. Therefore, if the definition of "customer" is revised as we recommend, we urge Treasury and the SEC to either provide an exception for broker-dealer representatives or confirm that they do not intend for such persons to be treated as fund customers under the final CIP rule.

7 5318 U.S.C. 31(l)(1), as amended by Section 326 of the Act (emphasis added).

8 Treating individuals who open accounts on behalf of an entity as customers would mitigate the possibility that sham corporations or other entities would be created for the purpose of laundering money.

9 Release, 67 Fed. Reg. at 48320.

10 Unlike a typical redemption, in an exchange, redemption proceeds are not returned to the shareholder and instead are used to purchase shares of a different fund in the same complex. As such, an exchange is closely analogous to a brokerage account customer's sale of one security and purchase of another within the same account.

11 Release, 67 Fed. Reg. at 48321.

12 See Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Judith R. Starr, Chief Counsel, Financial Crimes Enforcement Network, dated May 29, 2002. A copy of this letter is attached.

13 See Section 103.131(c)(1) of the Proposed Rule. The intermediary often may be reluctant to provide the information for business reasons. The customer likely would be confused and annoyed by such a request from a fund, having already provided the necessary information to the intermediary.

14 Release, 67 Fed. Reg. at 48323, citing H.R. Rep. No. 107-250, pt. 1, at 63 (2001).

15Financial Crimes Enforcement Network; Anti-Money Laundering Programs for Mutual Funds, 67 Fed. Reg. 21117 (Apr. 29, 2002).

16 The Proposed Rule takes a risk-based approach in requiring that CIP procedures be based on the type of identifying information available and on an assessment of relevant risk factors including, among others, the manner in which accounts are opened, fund shares are distributed, and purchases, sales and exchanges are effected. See Section 103.131(b) of the Proposed Rule.

17 Section 103.131(h) of the Proposed Rule.

18 Clearly, the recordkeeping requirements in the Proposed Rule also are intended to provide records to support future investigations relating to the account. However, we believe that identification records and records reflecting the resolution of material discrepancies are far more useful than verification records in this regard.

19 Section 103.131(i) of the Proposed Rule.

20 Release, 67 Fed. Reg. at 48323.

21 See, e.g., Role of Independent Directors of Investment Companies, SEC Release No. IC-24082, 64 Fed. Reg. 59826 at 59828 (Nov. 3, 1999).

22 Division of Investment Management, U.S. Securities and Exchange Commission, Protecting Investors: A Half Century of Investment Company Regulation, at 254 (1992).

23 See Customer Identification Programs for Banks, Savings Associations, and Credit Unions, 67 Fed. Reg. 48290 (July 23, 2002); Customer Identification Programs for Certain Banks (Credit Unions, Private Banks and Trust Companies) That Do Not Have a Federal Functional Regulator, 67 Fed. Reg. 58299 (July 23, 2002); Customer Identification Programs for Broker-Dealers, 67 Fed. Reg. 48306 (July 23, 2002); Customer Identification Programs for Futures Commission Merchants and Introducing Brokers, 67 Fed. Reg. 48328 (July 23, 2002).

24 Indeed, the broker-dealer and futures commission merchant CIP releases merely restate the approval requirement. The two CIP releases relating to banks explain that the requirement that the CIP be approved by a bank's board of directors or a committee of the board "highlights the responsibility of a bank's board of directors to approve and exercise general oversight over the bank's CIP." 67 Fed. Reg. at 48292 and 48301 (emphasis added).

25 We understand that the absence of a particular list on any such catalog would not absolve funds and other financial institutions from their compliance obligations with respect to that list. However, it would seem appropriate to limit the CIP rule to those lists identified by Treasury or the SEC.

26 See, e.g., Financial Crimes Enforcement Network; Anti-Money Laundering Programs for Money Services Businesses, 67 Fed. Reg. 21114 (Apr. 29, 2002); Financial Crimes Enforcement Network; Anti-Money Laundering Programs for Mutual Funds, 67 Fed. Reg. 21117 (Apr. 29, 2002); and Financial Crimes Enforcement Network; Anti-Money Laundering Programs for Operators of Credit Card Systems, 67 Fed. Reg. 21121 (Apr. 29, 2002).
