The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

COMMENT LETTER

March 1, 2002

Comment Letter on Proposed Suspicious Activity Reporting Rules, March 2002

March 1, 2002

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Department of the Treasury
P.O. Box 1618
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Re: NPRM—Suspicious Transaction Reporting—Brokers or Dealers in Securities

Dear Ms. Starr:

The Investment Company Institute[1] appreciates the opportunity to comment on the rule recently proposed by the Financial Crimes Enforcement Network (FinCEN) that would require brokers or dealers in securities (broker-dealers) to report suspicious transactions.[2]

The proposed rule would require all broker-dealers to report suspicious transactions to FinCEN. In general, transactions would be reportable if they are conducted or attempted by, at, or through a broker-dealer; involve or aggregate funds or other assets of at least $5,000; and involve any known or suspected violation of law or regulation, including a violation of Federal law, a suspicious transaction relating to money laundering, or a violation of the Bank Secrecy Act (BSA).[3]

We are commenting on this proposal because, as explained more fully below, transactions in fund shares[4] may be conducted by, at, or through the fund's principal underwriter, which is a broker-dealer. To provide the context for our specific comments on the proposed rule, our letter begins with a brief description of the three main entities with which we are concerned—the fund, its underwriter, and its transfer agent. Following this introductory section are our specific comments, which focus on four areas: (1) the application of the proposed rule to transactions involving fund shares; (2) reportable transactions; (3) the filing of suspicious activity reports by funds, fund underwriters, and/or fund transfer agents; and (4) the delegation of Treasury's authority to examine fund underwriters for compliance with the rule.

A. Background—The Fund, Its Underwriter, and Its Transfer Agent

The Fund. We use the term “fund” in this letter to refer to any investment company that is registered under the Investment Company Act of 1940. This includes open-end investment companies (commonly called mutual funds),5 closed-end investment companies,6 and unit investment trusts.7 It does not include the types of private investment companies commonly known as hedge funds. We note that the BSA does not define the term “investment company.” In adopting anti-money laundering rules applicable to “investment companies,” Treasury may wish to consider specifying which entities it intends to cover.8

Funds are legal entities formed pursuant to state law (most often as a corporation or business trust). Funds typically have no employees of their own. All of their functions are carried out by affiliated and/or unaffiliated service providers.

The Fund Underwriter. For purposes of this letter, the terms “underwriter” and “fund underwriter” mean a broker-dealer engaged in underwriting securities issued by funds. Underwriters are registered as broker-dealers under the Securities Exchange Act of 1934 and are subject to National Association of Securities Dealers, Inc. (NASD) rules governing mutual fund sales practices (although as discussed more fully below, the NASD’s suitability rules generally do not apply). The underwriter is responsible for offering the fund’s shares, either directly to the public or through broker-dealers and other financial intermediaries.

The Transfer Agent. Funds employ transfer agents to conduct recordkeeping and related functions. Transfer agents are registered as such under the Securities Exchange Act of 1934. Some fund transfer agents are banks or broker-dealers, but most are not.

Transfer agents maintain records of shareholder accounts and prepare and mail shareholder account statements, federal income tax information, and other shareholder notices. Transfer agents also may process transactions by accepting purchase payments and/or calculating and disbursing dividends and redemption proceeds. Some transfer agents prepare and mail statements confirming shareholder transactions and account balances, and maintain customer service departments to respond to shareholder inquiries.

B. The Application of the Proposed Rule to Transactions Involving Fund Shares

As a policy matter, the Institute believes that it is reasonable and appropriate to subject transactions in fund shares to risk-based SAR requirements as part of an overall strategy for guarding against potential money laundering activity in the U.S. financial services industry. That being said, we note that the application of the proposed broker-dealer SAR rule to transactions involving fund shares is not clear in all cases.

Many sales of fund shares occur through a retail broker-dealer. The application of the proposed rule to these types of transactions is fairly straightforward at the retail broker-dealer level. Such a transaction would be “conducted or attempted by, at, or through” the retail broker-dealer, and thus would be reportable by that retail broker-dealer.

At the level of the fund, its underwriter, and its transfer agent, however, the application of the rule is less clear. In particular, it is not clear when purchases, redemptions and

exchanges of fund shares would be considered to be conducted by, at, or through the fund underwriter. This is because the responsibilities of the underwriter and the fund's transfer agent may vary at different fund companies. For example, while all funds have transfer agents that maintain shareholder records and other information for an account on behalf of the fund, in some cases, the fund's transfer agent, rather than its underwriter, is the entity responsible for processing shareholder transactions. In these situations, it is unclear whether the transactions could be considered to have been conducted "by, at, or through" the underwriter. To the extent that these transactions are not considered to be conducted or attempted by, at, or through the fund underwriter, the rule as proposed would not apply. [9] This would result in substantially similar transactions receiving different treatment under the rule, based solely on the fund's distribution and shareholder servicing arrangements. To address this uncertainty, we recommend that Treasury clarify its intent regarding the application of the proposed rule to transactions involving fund shares.

In this regard, we understand that Treasury may be considering proposing an SAR rule specifically applicable to funds. We would support such an approach. It would avoid the potential problem of different treatment for substantially similar transactions and would allow funds flexibility to determine how their SAR responsibilities will be carried out. If Treasury decides to propose a fund SAR rule, we believe it would be appropriate to exclude fund underwriters from the broker-dealer SAR rule or, at a minimum, to provide that an SAR filed by a fund (or its agent) pursuant to a fund SAR rule would satisfy any reporting obligation of the fund's underwriter under the broker-dealer SAR rule with respect to the same transaction. This would not create any reporting gaps and it would reduce the number of redundant reports filed with FinCEN, thereby improving the overall efficiency of the SAR regime.[10]

Regardless of whether transactions in fund shares (at the fund/underwriter level) are subject to the proposed broker-dealer SAR rule or a separate fund rule, we urge Treasury to take the following comments into account. These comments would be equally relevant under either approach.

C. Reportable Transactions

1. The Standard for Identifying "Suspicious" Transactions

Under any SAR rule applicable to funds, their underwriters, or their transfer agents, it is critical that the standards for identifying reportable transactions take into account the nature of the fund business and the characteristics that distinguish it from the traditional banking and brokerage businesses. There are two such characteristics that we would like to highlight. First, a fund, its underwriter, and its transfer agent typically have no face-to-face contact with fund shareholders. Rather, contact with investors primarily is written or electronic—through the mail, over the Internet, or over the telephone. Second, unlike many retail broker-dealers, a fund underwriter generally does not make investment recommendations to investors. Instead, the underwriter acts merely as an order-taker. As a result, a fund underwriter is not required by the NASD to make suitability determinations with respect to transactions involving fund shares,[11] and often collects only limited information about shareholders.[12] Moreover, broker-sold funds commonly have omnibus accounts in the name of retail broker-dealers that sell the fund's shares. In these instances, its underwriter, and its transfer agent would not have any information about the retail broker-dealer's customers or their individual transactions.

The standard articulated in section 103.19(a)(2)(ii)(C) of the proposed rule fails to recognize

the nature of the information that a fund underwriter normally would have and instead appears to assume that the broker-dealer involved has suitability-type information available with which to make a determination as to whether a transaction is “suspicious.” That subparagraph provides that the broker-dealer must report a transaction if the broker-dealer knows, suspects, or has reason to suspect that the transaction (or a pattern of transactions of which it is a part) 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 broker-dealer knows of no reasonable explanation for it after examining the available facts, including the background and possible purpose of the transaction. The types of information normally obtained by a fund, its underwriter or its transfer agent likely would not enable them to identify the purpose of a given transaction and often may not make it possible to assess whether a transaction is “normal” for a particular investor.

To address this concern, we recommend that Treasury amend the proposed rule to provide that fund underwriters will be required to make determinations of what is “suspicious” based on information obtained by the fund, its underwriter, or its transfer agent in the normal course of establishing a shareholder relationship or processing transactions. More specifically, we suggest that Treasury either add the words “if such information is available to the broker-dealer” to the end of section 103.19(a)(2)(ii)(C) of the proposed rule, or delete the words “including the background and possible purpose of the transaction” from that section.13 To comply with the standard as we propose that it be revised, underwriters (either themselves or in conjunction with other agents of the fund) could, for example, monitor for “red flags” in the account opening process, and monitor transactions for suspicious methods of payment14 and suspicious patterns of activity, such as large redemptions.15 At a minimum, Treasury should clarify in the release adopting any SAR rule that will apply to fund transactions its expectation that a fund underwriter’s (or fund’s) SAR procedures should be based on information that the fund, its underwriter, or its transfer agent has obtained in the course of establishing a shareholder relationship or processing transactions.

Consistent with this, we also recommend that Treasury clarify in the release that when fund shares are held in the name of a broker-dealer or other intermediary (e.g., in an omnibus account), funds or their underwriters are not required to “look through” the broker-dealer or intermediary to report transactions of the broker-dealer’s or intermediary’s customers.16

2. The Scope of the Reporting Requirement

In the release accompanying the proposed broker-dealer SAR rule, Treasury indicates that it intends to create a “uniform reporting requirement for broker-dealers and banking organizations.”17 As proposed, however, the SAR rule for broker-dealers places two significantly broader reporting obligations on broker-dealers: (1) a requirement to report suspicious transactions related to all crimes, not just federal crimes; and (2) a requirement to report transactions amounting to less than $25,000 where a suspect has not been identified. The release does not discuss any policy or other reasons that might justify this disparate treatment.

Requirement to Report All Crimes. Unlike the regulations issued by the bank regulators, the proposed broker-dealer SAR rule does not appear to be limited to the reporting of known or suspected violations of federal law. Instead of requiring the reporting of “a known or suspected violation of Federal law, or a suspicious transaction related to a money laundering activity or a violation of the Bank Secrecy Act,”18 the proposal would require broker-dealers to report “any suspicious transaction relevant to a possible violation of law

or regulation, including “any known or suspected violation of Federal law, or a suspicious transaction related to a money laundering violation or a violation of the Bank Secrecy Act.”19 This would appear to require broker-dealers, in contrast to banking organizations, to report possible violations of law other than federal law, including violations of foreign, state or local laws. This would place a burden on broker-dealers to know, identify and report transactions that would violate foreign law (where the U.S. government has no jurisdiction to prosecute the crimes) and state and local laws (which would include petty offenses). We believe that, like banks, broker-dealers only should be required to report known or suspected violations of federal criminal law and should be encouraged to report other crimes voluntarily.

$25,000 Threshold for Unidentified Suspects. All of the regulations issued by the bank regulators provide a $25,000 reporting threshold for known or suspected federal crimes (other than money laundering or BSA violations) involving an unidentified suspect.20 The SAR proposal for broker-dealers does not contain a similar provision. Thus, the broker-dealer SAR proposal would require broker-dealers to file SARs for attempted or completed transactions or patterns of transactions that aggregate to $5,000 or more, even when there is no substantial basis for identifying a suspect. We do not believe that there is any law enforcement or other rationale for treating banks and broker-dealers differently in this situation.

Like banks, broker-dealers (including fund underwriters), funds and fund shareholders can be the victims of crimes such as check fraud and identity theft where it is frequently difficult, if not impossible, to identify a suspect. Requiring the filing of SARs for these transactions under the $25,000 threshold would be costly and burdensome and would clutter the SAR database with information that provides little, if any, useful information to law enforcement. Absent a determination by Treasury that these reports would “have a high degree of usefulness in criminal, tax, or regulatory investigations or proceedings, or in the conduct of intelligence or counterintelligence activities . . . to protect against international terrorism,”21 that the costs outweigh the burdens to financial institutions, and that a reasonable basis exists for treating broker-dealers differently from banks, we strongly urge Treasury to raise the threshold for reporting known or suspected crimes (other than money laundering or BSA violations) for unidentified suspects from $5,000 to $25,000.

D. The Filing of Suspicious Activity Reports by Funds, Underwriters, and/or Transfer Agents

To maximize its effectiveness, any SAR regime for transactions involving fund shares clearly should be designed to avoid potential reporting gaps. It also should seek to avoid multiple, redundant filings with respect to the same transaction.

In this regard, we note that in some instances, more than one “financial institution” with SAR obligations may be involved in a given fund transaction, such as the fund’s underwriter and transfer agent (if the transfer agent happens to be a bank or broker-dealer). Moreover, if Treasury adopts a separate SAR rule for funds, then funds themselves will be financial institutions required to report suspicious transactions.

We recommend that the SAR rule(s) applicable to transactions in fund shares allow a single report to satisfy the SAR obligations of the fund and its agents with respect to that transaction. This would be analogous to what Treasury has permitted for money services

businesses, where the applicable rule provides that:

The obligation to identify and properly and timely to report a suspicious transaction rests with each money services business involved in the transaction, provided that no more than one report is required to be filed by the money services businesses involved in a particular transaction (so long as the report filed contains all relevant facts). Whether, in addition to any liability on its own for failure to report, a money services business that issues the instrument or provides the funds transfer service involved in the transaction may be liable for the failure of another money services business involved in the transaction to report that transaction depends upon the nature of the contractual or other relationship between the businesses, and the legal effect of the facts and circumstances of the relationship and transaction involved, under general principles of the law of agency.22

This type of flexible, functional approach would allow funds that follow different business models to select the entity that is in the best position to file the reports, while avoiding any potential reporting gaps. Moreover, it would reduce the number of redundant reports filed with FinCEN, thereby improving the efficiency of the SAR regime.

The foregoing recommendation contemplates that, for example, the fund's transfer agent could file an SAR that would satisfy the fund underwriter's reporting obligations with respect to a particular transaction. This approach often may make the most sense functionally, since the transfer agent, rather than the fund underwriter, often processes fund transactions and maintains shareholder accounts on behalf of the fund, and therefore is in the best position to file the SAR. An issue may arise, however, since the limitation of liability under proposed section 103.19(f) does not appear to cover a transfer agent acting as agent for a fund.23 (It would extend to a transfer agent acting as agent for the fund underwriter.) Treasury therefore should amend the proposed rule to make clear that the safe harbor applies to any investment company or its agent that files a report relating to purchases, redemptions or exchanges involving that investment company's shares.24

E. Compliance Examinations

Paragraph (g) of the proposed rule states that compliance "shall be examined by the Department of the Treasury, through FinCEN or its delegees" under the terms of the BSA, and that "reports filed under this section shall be made available to an SRO registered with the Securities and Exchange Commission examining a broker-dealer for compliance with the requirements of this section." This seems to contemplate that FinCEN's examination authority might ultimately be delegated to NASD Regulation, Inc.

We believe that the SEC's Office of Compliance, Inspections and Examinations (OCIE)—which likely will be responsible for examining funds' compliance with the requirement under Section 352 of the USA PATRIOT Act to establish anti-money laundering programs (and compliance with any fund SAR rule)—would be the most appropriate entity to examine fund underwriters' compliance with applicable suspicious activity reporting requirements. Unlike NASD Regulation, Inc., which only has jurisdiction over broker-dealers, OCIE would be in a position to examine funds and their relevant service providers (e.g.,underwriters and transfer agents) in a comprehensive and integrated fashion for compliance with applicable anti-money laundering requirements.

* * *

The Institute appreciates the opportunity to express its views on this important issue. If you

have any questions about these matters, please contact me at (202) 326-5815, Frances Stadler at (202) 326-5822 or Bob Grohowski at (202) 371-5430.

Very truly yours,

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ENDNOTES

1 The Investment Company Institute is the national association of the American investment company industry. Its membership includes9,039 open-end investment companies ("mutual funds"), 486 closed-end investment companies and 6 sponsors of unit investment trusts. Its mutual fund members have assets of about $6.951trillion, accounting for approximately 95 percent of total industry assets, and over 88.6 million individual shareholders.

2 Proposed Amendment to the Bank Secrecy Act Regulations—Requirement of Brokers or Dealers in Securities to Report Suspicious Transactions, 66 Fed. Reg. 67670 (December 31, 2001).

3 Section 103.19(a) of the proposed rule.

4 For purposes of this letter, we refer to all purchases, redemptions, and exchanges involving securities issued by a fund as transactions in or involving fund shares.

5 A mutual fund is an investment company that pools money from shareholders and invests in a diversified portfolio of securities managed by the fund’s investment adviser. Investors purchase shares of the fund, each of which represents a proportionate ownership in all the fund’s underlying securities. Shares are redeemable. Funds also often allow shares to be exchanged for shares in another mutual fund sponsored by the same fund organization.

6 A closed-end fund is an investment company whose shares are listed on a stock exchange or are traded in the over-the-counter market. The fund’s portfolio is managed by an investment adviser. Shares are not redeemable, but may be repurchased by the fund periodically.

7 A unit investment trust (UIT) is an investment company that buys and holds a generally

fixed (unmanaged) portfolio of stocks, bonds, or other securities. “Units” in the trust are sold to investors (unitholders) who receive a share of principal and dividends (or interest). Units are redeemable securities, although the UIT sponsor may make a secondary market for them as well. A UIT has a stated date for termination that varies according to the investments held in its portfolio. When these trusts are dissolved, proceeds from the securities are either paid to unitholders or reinvested in another trust.

8 For example, it might be appropriate to treat closed-end investment companies differently from other funds and like other publicly traded issuers. The vast majority of transactions in shares of closed-end investment companies are effected through retail broker-dealers. Under the USA PATRIOT Act, broker-dealers are subject to a number of requirements that will provide anti-money laundering safeguards with respect to these transactions (e.g., suspicious activity reporting, customer identification and verification, and anti-money laundering programs).

9 Fund transfer agents that are banks or broker-dealers are or would be subject to their own SAR requirements.

10 See infra Section D.

11 See NASD Conduct Rule 2310. Of course, suitability requirements attach if any investment recommendation is made.

12 See NASD Conduct Rule 3110(c).

13 We would recommend the latter alternative only with respect to limited purpose broker-dealers, such as fund underwriters, that do not have background information on their customers.

14 These could include purchases of fund shares with travelers’ checks, money orders and other cash equivalents, checks drawn in foreign currency, and third-party checks and wire transfers. Many funds currently prohibit or limit the ability of investors to purchase shares with these types of instruments. See Report to the Chairman, Permanent Subcommittee on Investigations, Committee on Governmental Affairs, U.S. Senate, Anti-Money Laundering Efforts in the Securities Industry, GAO 02-111, October 2001 at 24-25 and fig.4. See also Investment Company Institute, “Money Laundering Compliance for Mutual Funds” (May 1999), at 20-28.

15 We note that patterns of activity may be more difficult to observe in fund accounts than in other types of financial accounts, since funds often are used as long-term savings vehicles. For example, a common pattern in a fund account may be a series of periodic investments followed by a large redemption. While a similar pattern might be suspicious in other contexts, in a fund account it may simply reflect an investor saving for a child’s education or to buy a home.

16 In cases where a broker-dealer or banks acts as an intermediary, a requirement to “look through” not only would impose an inappropriate burden on the fund underwriter but also would result in duplicative reporting because the broker-dealer or bank would have its own SAR responsibilities.

17 66 Fed. Reg. at 67672.

18 See, e.g., 12 C.F.R. § 208.62(a) (Federal Reserve Board); 12 C.F.R. § 21.11(a) (OCC); and

12 C.F.R. § 353.1 (FDIC) (emphasis added).

19 Proposed 31 C.F.R. § 103.19(a) (emphasis added). In the preamble to the proposed rule, Treasury also explains that "the rule requires the reporting of all activity 'relevant to a possible violation of law or regulation,' including 'any known or suspected violation of Federal law." 66 Fed. Reg. at 67672.

20 See, e.g., 12 C.F.R. § 208.62(c)(3) (Federal Reserve); 12 C.F.R. § 21.11(c)(3) (OCC), and 12 C.F.R. § 353.3(a)(3) (FDIC).

21 31 U.S.C. § 5311. See also California Bankers Association v Schultz, 416 U.S. 31 (1974).

22 31 CFR §103.20(a)(4).

23 Presumably, this issue would not arise under a rule specifically applicable to funds, since the limitation of liability provision would be written to extend to funds filing reports and their agents.

24 Under the BSA, investment companies are covered by a statutory safe harbor provided to all financial institutions. See 31 U.S.C. 5318. If Treasury chooses not to amend proposed section 103.19 as we recommend, it should at a minimum make clear that this statutory safe harbor also applies to any of an investment company's agents, including its transfer agents.
