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A legal update from Dechert's Financial Services Group

Treasury Issues Final Suspicious Activity Reporting Requirements for Mutual Funds

On May 4, 2006, the Treasury Department's Financial Crimes Enforcement Network ("FinCEN") published a final rule (the "Rule") requiring mutual funds to file Suspicious Activity Reports on Form SAR-SF, "Suspicious Activity Report by the Securities and Futures Industries."[1]

The Rule represents the latest in a series of new anti-money laundering obligations for mutual funds since the adoption of the USA PATRIOT Act. Under the Rule, mutual funds will have the same SAR filing requirements as banks, registered broker-dealers, and certain other financial institutions. Mutual funds will be required to file SAR-SFs regarding all suspicious transactions conducted by, at, or through a mutual fund after October 31, 2006.[2]

Background

The Bank Secrecy Act authorizes the Treasury Department to require any financial institution to "report any suspicious transaction relevant to a possible violation of law or regulation."[3] Financial institutions that file suspicious activity reports are prohibited from notifying the parties involved in the suspicious activity that a report has been filed, and enjoy a broad safe harbor protection from any civil liability that may arise from filing the report (or from failing to notify the parties that a report has been filed).[4] Banks, thrifts, and other depository institutions have been required to file suspicious activity reports since April 1996.[5]

Following the adoption of the USA PATRIOT Act, the Treasury Department issued rules that currently require registered broker-dealers to file suspicious activity reports on Form SAR-SF (for filings by persons in the securities and futures industries).[6] On January 15, 2002, the Treasury Department proposed the issuance of a SAR reporting rule for mutual funds (the "Proposed Rule").[7] The final Rule is substantially similar to the Proposed Rule.

SAR Filing Requirements Under the Rule

The Rule will require mutual funds to file SAR-SFs regarding suspicious activities that are conducted or attempted by, at, or through a

1 31 C.F.R. § 103.15; *see* FinCEN; Amendment to the Bank Secrecy Act Regulations—Requirement that Mutual Funds Report Suspicious Transactions, 71 Fed. Reg. 26213 (May 4, 2006).

2 The Rule would not apply to closed-end investment companies, rather it would apply only to "open-end managed investment companies described in the Investment Company Act of 1940. . . ." FinCEN; Amendment to the Bank Secrecy Act Regulations—Requirement that Mutual Funds Report Suspicious Transactions, 71 Fed. Reg. 26213, n.6 (May 4, 2006).

3 31 U.S.C. § 5318(g)(1).

4 *Id.* § 5318(g)(3).

5 31 C.F.R. § 103.18.

6 *Id.* § 103.19; *see* FinCEN; Amendment to the Bank Secrecy Act Regulations—Requirement that Brokers or Dealers in Securities Report Suspicious Transactions, 67 Fed. Reg. 44,048 (July 1, 2002) (preamble).

7 FinCEN; Amendment to the Bank Secrecy Act Regulations—Requirement that Mutual Funds Report Suspicious 68 Fed. Reg. 2716 (January 21, 2003).

mutual fund after October 31, 2006, and involve or aggregate at least $5,000 in funds or other assets, including currency and all other forms of payment, where the mutual fund knows, suspects, or has reason to know or suspect that the transaction (or a pattern of transactions of which the transaction is part):

- Involves funds derived from illegal activity or is intended or conducted in order to hide or disguise funds or assets derived from illegal activity (including, without limitation, the ownership, nature, source, location, or control of such funds or assets) 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;

- Is designed, whether through structuring or other means, to evade any requirements of the Rule or any other regulations promulgated under the BSA;

- 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

- Involves use of the mutual fund to facilitate criminal activity.[8]

While stressing that "it is not possible to provide an exhaustive list of suspicious transactions," the preamble to the Rule offers some guidance on the types of transactions that may require the filing of a report. For example, a SAR-SF may be warranted "if a mutual fund closes the account and redeems the shares of a customer whose identity the fund is unable to verify under its customer identification program," or in other situations where "a customer refuses to provide information necessary for the mutual fund to verify the customer's identity, make reports, or keep records required by [regulations promulgated under the BSA] or other regulations, provides information that the mutual fund determines to be false, or seeks to change or cancel a transaction after such person is informed of information verification or recordkeeping requirements relevant to the transactions."

The preamble to the Rule stresses that other situations may raise the need for more involved judgment. For example, a mutual fund should consider filing a SAR-SF regarding transactions exhibiting characteristics such as:

> (1) Transmission or receipt of funds transfers without normal identifying information, or in a manner that may indicate an attempt to disguise or hide the country of origin or destination, or the identity of the customer sending the funds, or the beneficiary to which the funds are sent; or (2) repeated use of a mutual fund as a temporary resting place for funds from multiple sources without a clear business (including investment) purpose.

Joint Reporting and the Roles of Service Providers

The Rule applies to mutual funds and not their affiliated persons. However, some fund affiliates, including broker-dealers, already are subject to separate reporting requirements. Because mutual funds conduct their operations through separate entities, the Rule permits a mutual fund to delegate contractually the performance of its reporting obligation to service providers, such as its transfer agent or distributor.

The mutual fund itself, however, would remain responsible for ensuring compliance with the Rule. To that end, the preamble to the Rule makes clear that a mutual fund should "take 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."

The preamble to the Rule acknowledges that mutual funds are often part of a larger fund complex, and that it is possible that more than one fund in the complex may be required to file a SAR-SF regarding the same transaction or pattern of transactions. Because of this, FinCEN clarifies in the Rule that all funds in a complex involved in a transaction or pattern of transactions may file a

[8] 31 C.F.R. § 103.15(a)(2). In response to an industry comment expressing concern that the "knows, suspects, or has reason to suspect" standard places an affirmative burden on a mutual fund to obtain more information regarding a customer than it already has, the preamble to the Rule states that funds will be expected to determine whether to file a SAR-SF based principally upon information they already obtain in the account opening process or in the normal course of processing transactions.

single, joint report on Form SAR-SF.[9] In the case of a joint report, each of the filers must retain a copy of the SAR-SF and its supporting documentation. In addition, the preamble states that a service provider may file a single joint report on behalf of more than one of the funds for which it provides services. The Rule also explicitly recognizes that, for a non-mutual fund affiliate of a fund that already is required to file a SAR regarding the same transaction or pattern of transactions as one or more mutual funds, the affiliate may file a joint report on behalf of all the mutual funds and any other financial institutions involved.

Treatment of Omnibus Accounts

The preamble states that a mutual fund may not have reason to suspect suspicious activity involving the use of omnibus accounts because mutual funds typically have little or no information regarding the identity of an intermediary's underlying customers. Therefore, the preamble makes clear that, in such a case, a mutual fund's customer is the omnibus account, rather than the underlying customer.[10]

Confidentiality of Reports and Safe Harbor

The Rule prohibits persons filing Form SAR-SF from making any disclosure, except to law enforcement and regulatory agencies, either about the reports themselves or supporting documentation.[11] However, the Rule does not prohibit a mutual fund from engaging in discussions with other financial institutions or service providers regarding whether a SAR-SF should be filed and what party should file it, or from providing the information to a service provider or other financial institution that would be necessary to file a joint SAR-SF.

The Rule also restates the statutory safe harbor from civil liability for persons filing Form SAR-SF. The safe harbor provision protects mutual funds, as well as their directors or trustees, officers, employees, and service providers (agents) from civil liability for filing the report (or from failing to notify a person that a report has been filed).[12]

Filing Procedures and Recordkeeping

The Rule requires a mutual fund to file Form SAR-SF within 30 days after the fund becomes aware of any suspicious transaction that takes place after October 31, 2006. If the mutual fund does not identify a suspect on the date of detection, the fund may delay filing Form SAR-SF for an additional 30 days, but in any event must report the transaction within 60 days of the initial detection.[13]

In situations that require immediate attention—such as the detection of a terrorist financing or ongoing money laundering schemes—the mutual fund must contact an appropriate law enforcement authority by telephone in addition to filing Form SAR-SF.[14] In such situations, the mutual fund may also similarly inform the SEC, but it is not required to do so.[15] Mutual funds must retain copies of SAR-SFs and the original related documentation for a period of five years from the date it files a SAR-SF or one is filed on its behalf.[16]

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9 The preamble to the Rule describes the procedures for filing a joint report, which include naming only one fund as the "filer" on the SAR-SF form, but including the names of the other applicable funds in the narrative section, along with the words "joint filing."

10 The preamble notes that if an omnibus accountholder is a foreign financial institution, the account would be considered a foreign correspondent account under Section 312 of the USA PATRIOT Act and may by subject to due diligence or enhanced due diligence pursuant to that Act and the regulations promulgated thereunder. *See* Anti-Money Laundering Programs; Special Due Diligence for Certain Foreign Accounts, 71 Fed. Reg. 496 (January 4, 2006).

11 31 C.F.R. § 103.15(d).

12 *Id.* § 103.15(e).

13 *Id.* § 103.15(b)(3).

14 *Id.* § 103.15(b)(4). This is a slight modification from the Proposed Rule, which merely encouraged the notification of appropriate law enforcement authorities. Mandatory reporting in situations like this is required by other financial institutions that are required to file SARs.

15 *Id.* § 103.15(b)(5).

16 *Id.* § 103.15(c). A mutual fund would have to make supporting documentation available to FinCEN, other law enforcement agencies, or federal or state securities regulators upon request.

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