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Anti-Money Laundering Developments for Mutual Funds

by Thomas C. Bogle and Jeanette Wingler

Rules adopted under the Bank Secrecy Act of 1970 (BSA) require mutual funds to implement anti-money laundering (AML) compliance programs.[1] Each mutual fund is required to implement an AML program reasonably designed to prevent the fund from being used for money laundering or terrorist financing activities, and to ensure compliance with its obligations under the BSA and the regulations thereunder. The Financial Crimes Enforcement Network (FinCEN), the bureau of the Treasury Department principally charged with administering the BSA, recently adopted new rules and guidance that impact the obligations of mutual funds under the BSA. This article discusses these new rules and guidance and their impact on mutual funds.

Expansion of 314(a) Information Sharing Program

Effective February 10, 2010, FinCEN adopted rule amendments that allow certain foreign law enforcement agencies, domestic state and local law enforcement agencies, and FinCEN itself, to submit Section 314(a) information requests to mutual funds and other financial institutions (the Information Sharing Amendments).[2]

Background

Section 314(a) of the USA PATRIOT ACT amended the BSA to permit the sharing

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of information among government agencies, law enforcement and financial institutions.[3] Rules adopted under Section 314(a) authorize FinCEN, at the request of law enforcement, to require US financial institutions to search their records to determine whether they have maintained an account or conducted a transaction with a person suspected of engaging in terrorist activity or money laundering (the 314(a) Program).[4] Before submitting a request to financial institutions concerning potential money laundering activity, FinCEN requires the requesting law enforcement agency to certify that the matter is significant, and that the requesting agency has been unable to locate the information through traditional methods of investigation and analysis before attempting to use this authority. Upon receiving the requisite certification, FinCEN may require any financial institution to search its records to determine whether the financial institution maintains or has maintained accounts for, or has engaged in transactions with, any specified individual, entity, or organization.

Foreign Law Enforcement Agencies

On September 23, 2008, the United States ratified the Agreement on Mutual Legal Assistance between the United States and the European Union (EU) (the US–EU MLAT) and 27 bilateral implementing agreements between the United States and EU Member States (each a Signatory State).[5] Article 4 of the US–EU MLAT obligates a requested Signatory State to search on a centralized database for bank accounts within its territory that may be important to a criminal investigation in the requesting Signatory State. Article 4 also contemplates that a Signatory State may request information in the possession of a non-bank financial institution.

The Information Sharing Amendments are, in part, intended to conform the 314(a) Program with the United States' obligations under the US–EU MLAT by allowing the law enforcement agencies of the Signatory States to submit information requests of financial institutions through FinCEN. Foreign law enforcement agencies are now able to use the 314(a) Program in a way analogous to how federal law enforcement agencies had been accessing the program prior to adoption of the Information Sharing Amendments. A foreign law enforcement agency, prior to initiating a query regarding a money laundering investigation under the 314(a) Program, must certify that the matter is significant and that such agency has been unable to locate the information sought through traditional methods of investigation and analysis. In the preamble to the Information Sharing Amendments, FinCEN stated that "a Federal law enforcement official serving as an attaché to the requesting jurisdiction will be notified of and will review the foreign request prior to its submission to FinCEN." These internal procedures are designed to ensure that the 314(a) Program is "utilized only in significant situations, thereby minimizing the cost on reporting financial institutions."

State and Local Law Enforcement Agencies and FinCEN

The Information Sharing Amendments also permit state and local law enforcement agencies to submit inquiries to financial institutions under the 314(a) Program. The preamble to the Information Sharing Amendments states that "[d]etection and deterrence of [money laundering and terror-related financial] crimes require[s] information sharing across all levels of investigative authorities, to include state and local enforcement, to ensure the broadest US Government defense." As with foreign law enforcement agencies, prior to initiating a query regarding a money laundering investigation under the 314(a) Program, a state or local law enforcement agency must certify that the matter is significant and that such agency has been unable to locate the information sought through traditional methods of investigation and analysis.

In addition, the Information Sharing Amendments allow FinCEN itself access to the 314(a) Program. FinCEN routinely assists the law enforcement community through proactive analyses to discover trends, patterns, and common activity in financial information contained in BSA reports. FinCEN anticipates "that the findings from the use of the 314(a) program will reveal additional

insights and overall patterns of suspicious financial activities." Unlike with respect to law enforcement agencies, the Information Sharing Amendments do not require that FinCEN certify that the matter is significant and that it has been unable to locate the information sought through traditional methods of investigation and analysis prior to initiating a query under the 314(a) Program.

Impact on Mutual Funds and Other US Financial Institutions

Mutual funds and other US financial institutions typically receive requests from FinCEN under the 314(a) Program every two weeks. The Information Sharing Amendments may result in more frequent or voluminous requests for financial institutions to search their accounts or transaction records, and it is possible that expansion of the 314(a) Program to include additional law enforcement and regulatory agencies will place additional compliance burdens on financial institutions. However, mutual funds should not have to amend their existing AML compliance programs to comply with the 314(a) Amendments.

New Guidance on Beneficial Ownership

On March 5, 2010, FinCEN, along with the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the National Credit Union Administration, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the Securities and Exchange Commission (SEC), in consultation with the Commodity Futures Trading Commission, issued a joint release entitled, "Guidance on Obtaining and Retaining Beneficial Ownership Information" (the Guidance).[6] The Guidance states that it is intended "to clarify and consolidate existing regulatory expectations for obtaining beneficial ownership information for certain accounts and customer relationships." For most financial institutions, however, the Guidance effectively creates a new legal obligation—never before articulated by the regulators—to "look through" certain account holders and verify the identity of certain beneficial owners.[7]

Background

In 2003, FinCEN and the SEC jointly adopted rules that require mutual funds to verify the identity of their customers.[8] For this purpose, the rules generally allow funds to treat the named account holder as their "customer."[9] FinCEN and the SEC had proposed to also require mutual funds to verify the identity of any person authorized to effect transactions in an account, but that proposal was not adopted.[10] Instead, a mutual fund's customer identification program (CIP) must address situations where the fund, consistent with a risk-based approach, will take steps to verify the identity of a customer that is *not an individual* by seeking information about individuals with authority or control over the account, including persons with authority to effect transactions in the account, *in order to verify the customer's identity*.[11] Accordingly, while a mutual fund may request additional information about higher-risk accounts opened by persons other than individuals, a fund ordinarily is not required to verify the identity of beneficial owners.

Furthermore, in numerous releases and guidance issued since the adoption of the USA PATRIOT Act in 2001, FinCEN and the SEC have acknowledged that mutual funds generally are not required to "look through" certain types of intermediated accounts to the identity of beneficial owners for purposes of complying with their broader AML responsibilities. For example, in the release adopting AML program requirements for mutual funds, FinCEN acknowledged that, in the case of omnibus accounts, "funds and their transfer agents do not know the identities of the individual investors. Only the distributor (for example, a broker-dealer) will have contact with the individual investors … and will have access to individuals' trading activity."[12] FinCEN stated that it did not expect a mutual fund to look as closely at activity in omnibus accounts as in individual accounts, but that the fund should instead "analyze the money laundering risk posed by particular omnibus accounts based upon a risk-based evaluation of relevant factors regarding the entity holding the omnibus account." Similarly, in adopting the CIP rule for mutual funds, FinCEN and the SEC stated that "with respect to an omnibus account established by

an intermediary, a mutual fund generally is not required to look through the intermediary to the underlying beneficial owners."

FinCEN and the SEC also have confirmed that mutual funds are not required to "look through" accounts opened by a broker-dealer or other financial intermediary through the National Securities Clearing Corporation's Fund/SERV system for purposes of the mutual fund CIP rule.[13] In guidance issued in 2003, FinCEN and the SEC said that "[t]hese accounts … function in a manner similar to omnibus accounts," and therefore a mutual fund need not verify the identity of persons that transact through such accounts—even in cases where the mutual fund has information about such persons.

There are several rules under the USA PATRIOT Act that may require mutual funds, under certain limited circumstances, to obtain information about beneficial owners—but only with respect to higher-risk accounts maintained for non-US persons. Mutual funds are required to establish and maintain a due diligence program reasonably designed to detect and report known or suspected money laundering or suspicious activity in "private banking accounts" for non-US persons.[14] Under the private banking account rule (which applies to mutual funds even though FinCEN recognizes such accounts are not offered by mutual funds[15]), a financial institution must take reasonable steps to identify nominal and beneficial owners of the foreign private banking account.[16] Mutual funds also are required to conduct due diligence on correspondent accounts maintained in the United States on behalf of foreign financial institutions.[17] Such due diligence may include obtaining information about persons that transact through such accounts, under appropriate circumstances.

The Guidance

The Guidance discusses three areas: (i) "customer due diligence" (CDD) procedures; (ii) private banking account due diligence programs; and (iii) foreign correspondent account due diligence programs. The discussion of the private banking account and foreign correspondent account due diligence programs essentially restates the regulatory requirements and related guidance that has previously been provided by FinCEN. However, the discussion regarding CDD procedures represents a new statement of policy never before articulated by FinCEN or the financial regulators.

The Guidance states that "a financial institution should establish and maintain CDD procedures that are reasonably designed to identify and verify the identity of beneficial owners of an account, as appropriate, based on the institution's evaluation of risk pertaining to an account." The Guidance does not define the term "beneficial owner" in this context. A footnote merely suggests that the definition of "beneficial owner" in FinCEN's regulation regarding due diligence for foreign private banking accounts "may be useful for the purposes of this guidance." That regulation defines "beneficial owner" of an account as:

> An individual who has a level of control over, or entitlement to, the funds or assets in the account that, as a practical matter, enables the individual, directly or indirectly, to control, manage or direct the account. The ability to fund the account or the entitlement to the funds of the account alone, however, without any corresponding authority to control, manage or direct the account (such as in the case of a minor child beneficiary), does not cause the individual to be a beneficial owner.[18]

The Guidance states that CDD procedures may include the following:

- Determining whether a customer is acting as an agent for or on behalf of another, and if so, obtaining information regarding the capacity in which and on whose behalf the customer is acting.

- Where the customer is a legal entity not publicly traded in the United States, including a private investment company (PIC), an unincorporated association, trust, or foundation, obtaining information about the ownership or structure of such entity so as to allow the financial institution to determine whether the account poses a heightened risk.

- Where the customer is a trustee, obtaining trust structure information sufficient to allow the financial institution to establish a reasonable understanding of such trust's structure and to determine the identity of the provider of funds and any persons or entities that have control over such funds or have the power to remove the trustee or trustees.

Importantly, while a financial institution's CDD procedures may be related to the financial institution's CIP, the Guidance states that it does not alter or supersede the CIP rules or the related guidance thereunder. In addition, the Guidance states that a financial institution's CDD procedures should be "commensurate with its BSA/AML risk, with particular focus on high risk customers." According to the Guidance, accounts maintained for certain trusts, corporate entities, shell entities and PICs "may pose heightened risk." If an account has been identified by a financial institution's CDD procedures as posing a heightened risk, such account should be subjected to enhanced due diligence (EDD) that is reasonably designed to ensure compliance with a financial institution's obligations under the BSA. The Guidance suggests that the EDD should include steps, in accordance with the level of risk presented by such account, "to identify and verify beneficial owners, to reasonably understand the sources and uses of funds in the account, and to reasonably understand the relationship between the customer and the beneficial owner."

According to the Guidance, "CDD and EDD information should be used for both monitoring purposes and for determining whether there are discrepancies between information obtained regarding an account's intended purpose and expected account activity and the actual sources of funds and uses of the account."

Implications for Mutual Funds

Because the Guidance is purportedly a restatement of existing regulatory expectations for financial institutions, it was effective upon publication. Mutual funds should review their AML programs promptly to determine whether any changes are required in light of the Guidance.

As noted above, in adopting the AML program rule for mutual funds, FinCEN stated that mutual funds were not expected to look through omnibus accounts to beneficial owners. Accordingly, it seems reasonable to conclude that the Guidance was not intended to alter the existing treatment of omnibus accounts by mutual funds. For similar reasons, a mutual fund should not be required to look through Fund/SERV accounts, which FinCEN has acknowledged "function in a manner similar to omnibus accounts." For other types of accounts, however, mutual funds and other financial institutions should consider the circumstances under which they will verify the identity of beneficial owners, consistent with the Guidance.

New Cash Reporting and Recordkeeping Requirements for Mutual Funds

On April 12, 2010, FinCEN issued a rule that defines mutual funds as a "financial institution" under the BSA regulations.[19] By being defined as such, mutual funds now are required to file currency transaction reports (CTRs) as opposed to reports on currency and certain bearer instruments on FinCEN/IRS Form 8300. Mutual funds also are required to comply with BSA rules requiring financial institutions to maintain records in connection with funds transfers and certain other transactions.

Filing CTRs

Prior to the adoption of the rule, mutual funds were required to report the receipt of cash, as well as the receipt of certain bearer instruments (for example, cashier's checks, travelers checks and money orders), in excess of $10,000 on FinCEN/IRS Form 8300.[20] Most mutual funds do not accept coin and currency, but mutual funds do accept bearer instruments. For this reason, mutual funds and their service providers were required to monitor the receipt of bearer instruments in order to determine whether they needed to file FinCEN/IRS Form 8300.

With the adoption of the rule, mutual funds no longer are required to file FinCEN/IRS Form 8300, and instead are required to file CTRs.[21] The CTR form only requires reporting

of currency—not bearer instruments. Because mutual funds generally do not engage in transactions in currency, the rule should significantly streamline mutual fund transaction monitoring and compliance costs.

Related Recordkeeping Requirements

The rule also means that mutual funds must comply with requirements regarding the creation and retention of records for transmittals of funds, and the requirement to transmit information on these transactions to other financial institutions in the payment chain (the Recordkeeping and Travel Rule), effective January 10, 2011.[22] The Recordkeeping and Travel Rule applies to transmittals of funds in amounts that equal or exceed $3,000 and requires that the recipient's financial institution, and in certain instances the transmittor's financial institution, obtain or retain identifying information on the recipient.[23] In accordance with the Recordkeeping and Travel Rule, certain information obtained or retained by the transmittor's financial institution should "travel" with the transmittal order through the payment chain.

In addition, mutual funds are subject to requirements regarding the creation and retention of records for extensions of credit and cross-border transfers of currency, monetary instruments, checks, investments and credits.[24] These requirements apply to transactions in amounts exceeding $10,000, and also are effective January 10, 2011.

Although FinCEN believes that these recordkeeping requirements will have a "*de minimis* impact" on mutual funds and their transfer agents in light of their existing record retention requirements, many mutual fund transfer agents will need to upgrade their systems in order to comply with the Recordkeeping and Travel Rule.

Conclusion

Each of these new rules and guidance directly impacts the AML responsibilities of mutual funds. In light of the new rules and guidance, mutual funds should update their AML compliance programs and related internal controls. Furthermore, because a mutual fund's AML program must be part of the fund's Rule 38a-1 compliance program, mutual fund boards and chief compliance officers should consider these new rules and guidance in connection with the annual review of the fund's compliance program.

Notes

1. 31 C.F.R. §103.130.

2. FinCEN, *Expansion of Special Information Sharing Procedures to Deter Money Laundering and Terrorist Activity,* 75 Fed. Reg. 6560 (Feb. 10, 2010).

3. USA PATRIOT Act §314(a), Pub. L. No. 107-56, 115 Stat. 272 (Oct. 26, 2001).

4. 31 C.F.R. §103.100.

5. Signatory States include the United States, Austria, Belgium, Bulgaria, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, The Irish Republic, Italy, Latvia, Lithuania, Luxembourg, Malta, The Netherlands, Poland, Portugal, Romania, Slovakia, Slovenia, Spain, Sweden and the United Kingdom.

6. FinCEN, *Guidance on Obtaining and Retaining Beneficial Ownership Information* (Mar. 5, 2010), available at *http://www.fincen.gov/statutes_regs/guidance/html/fin-2010-g001.html*.

7. In adopting the Guidance, the SEC indicated that it was merely clarifying and consolidating "existing regulatory expectations for obtaining beneficial ownership information for certain accounts and customer relationships," and that the provisions of the Administrative Procedure Act requiring notice of proposed rulemaking, opportunity for public comment, and prior publication therefore were not applicable. *Policy Statement on Obtaining and Retaining Beneficial Ownership Information for Anti-Money Laundering Purposes*, SEC Release No. 34-61651 (Mar. 5, 2010). However, the SEC cites to no release, no-action relief, or other authority to support this statement.

8. *See Customer Identification Programs for Mutual Funds*, SEC Release No. IC-26031 (Apr. 29, 2003).

9. 31 C.F.R. §103.131(c)(2)(i).

10. *Customer Identification Programs for Mutual Funds*, SEC Release No. IC-25657 (July 12, 2002) (proposed rule).

11. *See, e.g.*, 31 C.F.R. §103.131(b)(2)(ii)(C).

12. FinCEN, *Anti-Money Laundering Programs for Mutual Funds*, 67 Fed. Reg. 21,117, 21,118 (Apr. 29, 2002).

13. FinCEN and SEC, Questions and Answers Regarding the Mutual Fund Customer Identification Program Rule (Aug. 11, 2003), available at *http://www.sec.gov/divisions/investment/guidance/qamutualfund.htm.*

14. 31 C.F.R. §103.175.

15. *See* FinCEN, *Anti-Money Laundering Programs; Special Due Diligence Programs for Certain Foreign Accounts,* 71 Fed. Reg. 496, 505 (Jan. 4, 2006).

16. 31 C.F.R. §103.178(b)(1).

17. *Id.* §103.176; *see also id.* §103.177 (requiring certain financial institutions, but not mutual funds, to obtain information about ownership of foreign banks for which the financial institution maintains a correspondent account in the United States).

18. *Id.* §103.175(b).

19. FinCEN, *Amendment to the BSA Regulations, Defining Mutual Funds as Financial Institutions,* 75 Fed. Reg. 19,241 (Apr. 14, 2010).

20. 31 C.F.R. §103.30.

21. *Id.* §103.22.

22. *Id.* §§103.33(f), (g).

23. A "transmittal of funds" includes fund transfers processed by banks, as well as similar payments, where one or more of the financial institutions processing the payment is not a bank. If the mutual fund is processing a payment sent by or to its customer, then the mutual fund would be either the "transmittor's financial institution" or the "recipient's financial institution." *Id.* §103.11(jj).

24. *Id.* §§103.33(a)–(c).

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