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By Electronic Transmission

James H. Freis, Jr.
Director, Financial Crimes Enforcement Network
U.S. Department of the Treasury
P.O. Box 39
Vienna, VA 22183

Re: Docket Number FINCEN-2012-0001

Dear Mr. Freis:

The Investment Company Institute ("ICI")[1] appreciates the opportunity to comment on the advance notice of proposed rulemaking issued by the Financial Crimes Enforcement Network ("FinCEN") seeking comment on a wide range of questions relating to the development of an explicit customer due diligence ("CDD") obligation for financial institutions (the "ANPRM").[2] The ANPRM describes FinCEN's concern with the lack of uniformity and consistency in the way financial institutions address CDD and beneficial ownership. FinCEN therefore believes that issuing an express CDD rule, including a requirement to obtain beneficial ownership information, may be necessary to protect the United States financial system from criminal abuse and to guard against terrorist financing, money laundering and other financial crimes.

I. Executive Summary

The ICI and its members have long supported the government's efforts to combat money laundering activity in the financial services industry, and we remain committed to working with FinCEN and the

[1] The Investment Company Institute ("ICI") is the national association of U.S. registered investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of $13.4 trillion and serve over 90 million shareholders.

[2] Customer Due Diligence Requirements for Financial Institutions, 77 FR 13,046 (proposed March 5, 2012), available at http://www.gpo.gov/fdsys/pkg/FR-2012-03-05/pdf/2012-5187.pdf (the "ANPRM").

Securities and Exchange Commission ("SEC") on effective improvements to the U.S. anti-money laundering ("AML") regime applicable to mutual funds, where necessary.[3] While we recognize FinCEN's rationale for considering the adoption of an explicit CDD rule, FinCEN must fully understand and evaluate the ramifications of such a rule on the various and different types of financial institutions, including mutual funds, and the costs and benefits of such a requirement, prior to proposing a CDD rule. In summary, we note the following:

- It is critical that any CDD rule take into account the unique relationship among mutual funds, intermediaries and fund shareholders, and recognize that most mutual fund accounts are either low-risk employer sponsored retirement plans, or are introduced through intermediaries (that are primarily financial institutions) that have the direct relationship with the fund's shareholder. Consequently, given the expertise and experience of the SEC's Division of Investment Management with mutual funds, and because the ANPRM incorporates elements of Section 326 of the USA PATRIOT Act, we believe that any CDD rule applicable to mutual funds should be adopted jointly by both FinCEN and the SEC.

- We believe that the concept of CDD, as described in the ANPRM, represents a fundamental change to the AML requirements applicable to mutual funds, and that any cost/benefit analysis of a proposed CDD rule must start from the presumption that mutual funds currently are not subject to formal CDD obligations.

- The notion of understanding the "nature and purpose" of an account, as described in the ANPRM, is inconsistent with the existing regulatory obligations of mutual funds, and is particularly impracticable given the highly intermediated nature of the industry.

- Because Congress never intended that mutual funds be required to identify or verify beneficial owners under the Bank Secrecy Act ("BSA"), and given the low-risk customer base of mutual funds, FinCEN, as part of a cost/benefit analysis, should precisely indicate the statutory basis for subjecting mutual funds to beneficial ownership requirements and the reasons why it is now appropriate to subject mutual funds to such requirements.

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[3] *See*, *e.g.*, Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Judith R. Starr, Chief Counsel, Financial Crimes Enforcement Network (May 29, 2002). The term "mutual fund" means an open-end investment company as defined in Section 5(a)(1) of the Investment Company Act of 1940 (15 U.S.C. 80a–5(a)(1)).

- Requiring mutual funds to obtain beneficial ownership information is ineffective, because beneficial ownership information cannot be reliably verified until such time as entities are required to disclose such information at the time of their formation.

- The definition of "beneficial owner" in the ANPRM is vague and unworkable. Approaches used outside the United States for identifying controlling beneficial owners should be considered.

- Notwithstanding our concerns about the ANPRM, we believe that it is reasonable for mutual funds to obtain additional information, including beneficial ownership information, on a risk-based determination, and to verify such information on a risk sensitive basis in a manner similar to what is required by the CIP rules. However, mutual funds should not be required to obtain or verify beneficial ownership information in the context of customer relationships exempt from the mutual fund CIP rule, or from intermediaries holding shares through omnibus accounts[4] or accounts that function in a manner similar to omnibus accounts. Moreover, mutual funds should be allowed to apply simplified due diligence, and not obtain beneficial ownership information, in connection with customer relationships introduced by regulated intermediaries.

II. Mutual Funds, Intermediaries and Fund Shareholders[5]

The mutual fund industry operates differently from other financial institutions in many respects, including in ways that are directly relevant to the consideration of a mutual fund's AML obligations. While some fund complexes allow shareholders to transact directly with a mutual fund through its transfer agent,[6] in most cases shareholders establish accounts and transact with a mutual fund through a

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[4] *See* Appendix A to this letter, which describes the relationship among mutual funds, intermediaries and fund shareholders, including omnibus accounts.

[5] *See generally* ICI and INDEPENDENT DIRECTORS COUNCIL, NAVIGATING INTERMEDIARY RELATIONSHIPS (Sept. 2009), *available at* http://www.ici.org/pdf/ppr_09_nav_relationships.pdf ("2009 Intermediary Paper") and Appendix A.

[6] For individual customer accounts established directly with the fund, the fund's transfer agent maintains records of accounts, calculates and distributes dividends and capital gains, and prepares and mails account statements confirming transactions and account balances, federal income tax information, and other shareholder notices. Some transfer agents also maintain customer service departments, including call centers, to respond to shareholder inquiries. For omnibus accounts and individual accounts controlled exclusively by an intermediary, the intermediary provides to the investor the following: trade confirmations, statements, and investment information; any tax reporting; and required shareholder communication. Additional information about the role of mutual fund transfer agents is provided in the Appendix A to this letter and the 2009 Intermediary Paper.

financial representative who works for, or processes trades through, an intermediary, which is often a regulated institution (*e.g.*, broker-dealer, registered investment adviser).[7] In summary, we note the following important facts:

- ICI research shows that ***69 percent of mutual fund-owning households own mutual funds through an employer-sponsored retirement plan***.[8] FinCEN and the SEC have acknowledged that "these accounts are less susceptible to use for the financing of terrorism and money laundering, because, among other reasons, they are funded through payroll deductions in connection with employer plans that must comply with federal regulations that impose various requirements regarding the funding and withdrawal of funds from such accounts, including low contribution limits and strict distribution requirements."[9]

- For those remaining mutual fund accounts that are not established through an employer-sponsored retirement plan, ICI research has found that ***80 percent of investors purchased their fund shares through an intermediary, such as a broker-dealer, a bank trust department, or an insurance company***.[10] In these cases, the intermediary, not the mutual fund, is the party that has the direct relationship with the fund shareholder.

- ***A significant trend in customer recordkeeping by intermediaries is the shift away from intermediary controlled individual accounts to omnibus account structures. This trend is noticeably reducing the number of individual accounts on a fund's books and also reducing***

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[7] Investors use intermediaries to obtain a number of benefits. Intermediaries can be a single point of contact for financial planning expertise and other services and also may provide access to an array of investment choices, e.g., stocks, bonds, mutual funds, annuities. There are also a variety of intermediary service models. *See Why Do Mutual Fund Investors Use Professional Financial Advisers*, ICI Research Fundamentals, Volume 16, No. 1 (April 2007) available at http://www.ici.org/pdf/fm-v16n1.pdf.

[8] *See* "Rulemaking Must Reflect Realities of Funds' Access to Shareholder Information," *ICI Viewpoint,* available at http://www.ici.org/viewpoints; and "Profile of Mutual Fund Shareholders, 2011," *ICI Research Report* (February 2012), available at http://www.ici.org/pdf/rpt_12_profiles.pdf.

[9] Joint Final Rule: Customer Identification Programs for Mutual Funds, SEC Release No. IC-26031 (Apr. 29, 2003) ("Mutual Fund CIP Rule").

[10] *See* "Rulemaking Must Reflect Realities of Funds' Access to Shareholder Information," *ICI Viewpoint,* available at http://www.ici.org/viewpoints; and "Profile of Mutual Fund Shareholders, 2011," *ICI Research Report* (February 2012), available at http://www.ici.org/pdf/rpt_12_profiles.pdf.

the amount and type of information that funds have regarding underlying shareholders.[11] In the case of omnibus accounts, the fund's recordkeeper does not have access to the individual identities of the underlying shareholders; it knows only the intermediary acting on behalf of the intermediary's clients. The fund's recordkeeper has the transactional history for the omnibus account as a whole, but does not have access to an individual transaction history for each underlying shareholder for whom transactions are typically aggregated and transmitted by the intermediary for the omnibus account. For this reason, FinCEN previously has acknowledged that a mutual fund is not expected to "obtain any additional information regarding individual transactions that are processed through another entity's omnibus account."[12]

- ***A substantial majority of mutual fund assets are held through intermediaries, which increasingly are using omnibus accounts to transact in mutual funds, or retirement plans, where FinCEN has recognized the money laundering and terrorist financing risks are insignificant.***

III. FinCEN Should Propose a Mutual Fund CDD Rule Jointly with the Securities and Exchange Commission

Because mutual fund customer relationships are generally low risk (*e.g.*, employer-sponsored plans) or established through intermediaries, it is critical that any CDD rule take into account the unique characteristics of the mutual fund shareholder servicing model. As stated above, we believe that any CDD rule applicable to mutual funds should be adopted jointly by both FinCEN and the SEC.

FinCEN is primarily responsible for issuing regulations under the BSA. However, in adopting the USA PATRIOT Act, Congress created a special rule for regulations pertaining to the identification and verification of customers of financial institutions. Specifically, Section 326 of the USA PATRIOT Act directs the Secretary of the Treasury (through FinCEN) to prescribe regulations setting forth minimum standards regarding the identity of the customer that shall apply in connection with the opening of an account with a financial institution.[13] The statute provides that, in the case of certain federally regulated

[11] Recent statistics provided by the Depository Trust and Clearing Corporation show over the past year approximately a 24% decline in the number of intermediary controlled individual accounts, from approximately 67 million accounts in February 2011 to 51 million accounts as of February 2012, primarily due to omnibus account conversions.

[12] Anti-Money Laundering Programs for Mutual Funds, 67 Fed. Reg. 21,117, 21,120 (Apr. 29, 2002) ("Mutual Fund AML Program Rule").

[13] USA PATRIOT Act § 326, *codified at* 31 U.S.C. § 5318(l).

financial institutions, including mutual funds, the regulations issued under Section 326 *must* be prescribed jointly with the financial institution's federal functional regulator.[14] The House Report accompanying Title III of the USA PATRIOT Act explains the reason for requiring FinCEN to consult, and issue rules jointly, with a financial institution's federal regulator, noting that this approach "will help ensure that the regulations are appropriately tailored to the business practices of various types of financial institutions, and the risks that such practices may pose."[15] Consistent with this authority, in 2003 FinCEN and the SEC jointly adopted a CIP rule that requires mutual funds to verify the identity of persons that open an account.[16]

The CDD rule envisaged by the ANPRM incorporates many elements of Section 326 of the USA PATRIOT Act. Indeed, the ANPRM states that the first element of CDD – conducting initial due diligence on customers – would be satisfied entirely by compliance with a financial institution's CIP obligation.[17] In addition, the third element of the CDD described in the ANPRM – identifying the beneficial owners of all customers, and verifying the identity of beneficial owners pursuant to a risk-based approach – borrows heavily from concepts embedded in Section 326 of the USA PATRIOT Act. For example, the ANPRM states that the beneficial ownership concept is "[c]onsistent with … explicit and implicit beneficial ownership obligations" in the BSA rules, including the requirement in the CIP rules that financial institutions obtain information about persons with authority or control over accounts opened by non-individuals on a risk-based approach.[18] FinCEN also states that, under the CDD rule, financial institutions presumably would use "procedures similar to those currently required by the CIP rules" to verify beneficial owners of a customer.[19]

Because the ANPRM incorporates many of the elements of Section 326 of the USA PATRIOT Act, we believe that any CDD rule applicable to mutual funds should be adopted in a manner consistent with the procedural requirements Congress built into Section 326. We also note that the 2010

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[14] *Id.* § 5318(l)(4).

[15] H.R. REP. NO. 107-250 (2001).

[16] Mutual Fund CIP Rule, *supra* note 9.

[17] ANPRM, *supra* note 2, at 13,050 ("[i]f a financial institution is compliant with its CIP obligations, a financial institution would be compliant with this part of the CDD rule and therefore there would be no new or additional regulatory obligation").

[18] *Id.* at 13,053.

[19] *Id.*

beneficial ownership and CDD guidance was issued jointly by FinCEN and the federal functional regulators, including the SEC.[20] Further, given the expertise and experience of the staff of the SEC's Division of Investment Management with respect to understanding the operations of mutual funds, we believe that their involvement in any CDD rulemaking applicable to mutual funds is critical to ensuring a workable rule. The involvement of the SEC's Division of Investment Management in recent regulations applicable to mutual funds, such as the "pay to play" rule, has been instrumental in the adoption of workable approaches.[21]

The rulemaking approach we propose would be consistent with congressional intent and would allow an opportunity for the regulators to provide tailored CDD guidance to mutual funds similar to the tailored guidance provided to mutual funds under the CIP rules.

IV. Proposed Elements for a CDD Rule Raise Significant Concerns for Mutual Funds

The ANPRM states that "the cornerstone of a strong BSA/AML compliance program is the adoption and implementation of internal controls, which include comprehensive CDD policies, procedures, and processes for all customers, particularly those that present a high risk for money laundering or terrorist financing," and notes that this has been reflected in recent guidance and enforcement actions.[22] FinCEN further explains that an effective CDD program should provide a financial institution with sufficient information to develop a customer risk profile that can be used by a financial institution to

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[20] *Guidance on Obtaining and Retaining Beneficial Ownership Information*, FinCEN Guidance, FIN-2010-G001 (Mar. 5, 2010) ("March 2010 Guidance"). We would expect that any CDD rule would overrule and supersede the March 2010 Guidance, the substance of which was strongly questioned by the ICI and other industry associations. *See* Letter from the Investment Company Institute, the Securities and Financial Markets Association, and the Futures Industry Association to staff of the SEC (June 9, 2010), *available at* http://www.ici.org/pdf/24354.pdf ("June 2010 Letter"), and attached to this letter as Appendix B.

[21] *See, i.e.,* No-Action Letter, Response of the Office of Chief Counsel, Division of Investment Management, to the Investment Company Institute, dated Sept. 12, 2011, regarding Rule 204-2(a)(18)(i)(B) under the Investment Advisers Act of 1940 (the "Government Plan Recordkeeping Rule"), available at http://www.sec.gov/divisions/investment/noaction/2011/ici091211-204.htm. The SEC adopted the Government Plan Recordkeeping Rule in conjunction with the pay to play rule under the Act, Rule 206(4)-5. *Political Contributions by Certain Investment Advisers*, SEC Release No. IA -3043 (Jul. 1, 2010). The no-action letter acknowledges the difficulties mutual funds have in tracing through various levels of ownership resulting from omnibus and similar account holdings.

[22] ANPRM, *supra* note 2.

identify higher-risk customers and accounts, including customers and accounts subject to special or enhanced due diligence.[23]

FinCEN then outlines the four elements it believes should be included in an effective CDD program:

(1) conducting due diligence on customers, which includes identifying the customer, and verifying that customer's identity as appropriate on a risk basis, at the time of account opening;

(2) understanding the purpose and intended nature of the account, and expected activity associated with the account for the purpose of assessing risk and identifying and reporting suspicious activity;

(3) except as otherwise provided, identifying the beneficial owner(s) of all customers, and verifying the beneficial owner(s) identity pursuant to a risk-based approach; and

(4) conducting ongoing monitoring of the customer relationship and conducting additional CDD as appropriate, based on such monitoring and scrutiny, for the purposes of identifying and reporting suspicious activity.

Consistent with a risk-based AML program, mutual funds and their transfer agents have processes and controls that take into consideration the risks associated with customer relationships established with a mutual fund; however, the requirements and activities contemplated under the ANPRM greatly exceed existing requirements and industry practices. Because the type of CDD rule contemplated under the ANPRM would impose a new BSA requirement upon mutual funds, we stress that the benefits of any such obligation must be carefully weighed against the costs of implementation, and the regulation must be thoughtfully crafted. We describe below our key concerns with the CDD elements that FinCEN is considering, particularly as they would apply to mutual funds.

A. <u>CDD as Proposed in the ANPRM is New</u>

The ICI strongly supports FinCEN's efforts to encourage financial institutions to implement robust, risk-based AML programs. However, we believe it is important to recognize that an express CDD rule would represent a fundamental change to the BSA requirements currently applicable to mutual funds

[23] ANPRM, *supra* note 2, at 13,047.

and the need for such a meaningful change has not been demonstrated.[24] For this reason, any cost/benefit analysis of a proposed CDD rule must start from the presumption that mutual funds currently are not subject to formal CDD obligations.

Mutual funds currently verify the identity of their customers, consistent with the Mutual Fund CIP Rule.[25] Under that rule, a mutual fund is required to identify and verify each customer to the extent reasonably and practicable. The term "customer" is defined as the person that opens a new account. Notably, mutual funds are not required to verify the identity of certain readily identifiable customers. These include regulated U.S. financial institutions, U.S. and state government entities, publicly-traded companies and other low-risk customers.[26] Mutual funds also are not required to verify the identity of customers establishing certain types of accounts, such as accounts opened for the purpose of participating in an employee benefit plan established pursuant to the Employee Retirement Income Security Act of 1974 ("ERISA").[27] When crafting the exemptions from the CIP rules, FinCEN and the federal functional regulators took into account the low money laundering and terrorist financing risks associated with certain types of customer relationships, and determined that financial institutions should not be required to apply their CIP procedures to those relationships.[28]

In contrast to the limited identification and verification required by the CIP rules, Section 312 of the USA PATRIOT Act requires financial institutions to conduct broader due diligence on accounts established or maintained for certain foreign persons, but these rules apply only to "correspondent accounts" maintained for foreign financial institutions and "private banking accounts" maintained for certain foreign persons. In adopting Section 312, Congress presumably felt it necessary to mandate due diligence requirements for these types of accounts that exceed what financial institutions are expected to perform on their broader customer base. In the ANPRM, however, FinCEN appears to envisage a

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[24] We appreciate FinCEN's acknowledgement in the ANPRM that "there is at least some question about the nature of a financial institution's obligation to conduct CDD and to obtain beneficial ownership information." ANPRM, *supra* note 2, at 13,048. ICI continues to disagree with FinCEN's view that "customer due diligence" represents an existing regulatory expectation previously communicated by the regulators to securities and futures firms. See June 2010 Letter, *supra* note 20.

[25] *See* Mutual Fund CIP Rule, *supra* note 9.

[26] *See* 31 C.F.R. § 1010.100(c)(2).

[27] *See id.* § 1010.100(a)(2).

[28] FinCEN and the federal financial regulators initially proposed to require financial institutions to both identify and verify the identity or "any person authorized to effect transactions in a customer's account," but that proposal was not adopted. *See* Customer Identification Programs for Mutual Funds, SEC Release No. IC-25657 (July 15, 2002) (proposed rule).

CDD obligation for *all* customer relationships that is very similar to a financial institution's obligations with respect to "correspondent accounts" and "private banking accounts." Accordingly, FinCEN should clarify that CDD, as described in the ANPRM, is not intended to apply the more stringent due diligence requirements of Section 312 of the USA PATRIOT Act to all customer relationships.

B. Requirement to Understand the Nature and Purpose of Account Must be Applied Uniquely to Mutual Funds

In the ANPRM, FinCEN proposes that the second element of a CDD program include the requirement to understand the nature and purpose of the account and expected activity associated with the account for the purpose of assessing the risk and identifying and reporting suspicious activity. With reference to a financial institution's suspicious activity reporting procedures, FinCEN explains that, "in discerning whether a transaction or series of transactions is suspicious, a financial institution must determine if the activity varies from the normal activity or activities appropriate for the particular customer or class of customer, and has no apparent reasonable explanation."[29] FinCEN further advises that, "because in FinCEN's view, a financial institution must understand the nature and purpose of an account in order to assess the risk and satisfy its obligation to appropriately detect and report suspicious activity, FinCEN does not believe that this will impose a new or additional requirement."[30]

We are concerned about the scope of this proposed CDD element because, as described in the ANPRM, the notion of understanding the "nature and purpose" of an account does not accurately reflect the existing regulatory obligations of mutual funds, and is impracticable given the nature of the mutual fund industry. Specifically, mutual funds do not have an obligation to determine the suitability of an investment in a fund, and therefore would have a very limited perspective on the "purpose" of the account or the "expected account activity" prior to opening the account.[31] Even in instances where shares are held directly with the fund, the relationship between the fund and the shareholder is different from the relationship between full service brokers and banks and their customers. Therefore,

[29] ANPRM, *supra* note 2, at 13,051.

[30] *Id.*

[31] In contrast, certain intermediaries may have additional information about the "nature and purpose" of an account, consistent with an intermediary's suitability and related obligations under the federal securities laws.

the unique relationship between a mutual fund and its shareholders must inform FinCEN's expectations with respect to the application of CDD for mutual funds.[32]

Given the intermediated nature of the industry, as well as the omnibus nature of many accounts, mutual funds simply do not have access to this type of information for the vast majority of their customer relationships.[33] To the extent the ANPRM implies that mutual funds are expected to obtain additional information about an account *for the purpose of determining whether to file a SAR*, we believe that would directly conflict with guidance provided by FinCEN in 2006. In response to a specific question asking whether "a mutual fund [is] expected to obtain additional information (*i.e.*, that it does not already have) to meet the 'knows, suspects, or has reason to suspect' standard" of the mutual fund SAR rule, FinCEN stated that a fund "should be able to meet the 'knows, suspects, or has reason to suspect' standard … based on information available to the mutual fund that was obtained through the account opening process and in the course of processing transactions…."[34] We accordingly request that any CDD rule for mutual funds acknowledge that funds are expected to file SARs based on information already available to a fund through the account opening process and in the course of processing transactions, consistent with FinCEN's 2006 guidance.

C. Beneficial Ownership Element of CDD Proposal Raises Numerous Concerns

1. *Conflicts with Congressional Intent and Prior Treasury Positions*

FinCEN is contemplating including an element in the CDD rule that would state, "[e]xcept as otherwise provided, financial institutions shall identify the beneficial owner(s) of all customers, and verify the beneficial owners' identity pursuant to a risk-based approach."

As discussed above, mutual funds are not always in the best position to obtain information about and verify beneficial owners. Congress acknowledged as much when adopting the USA PATRIOT Act.

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[32] In this regard, any CDD rule should acknowledge that the "nature and purpose" of certain accounts is self-evident (e.g., employee retirement plan accounts).

[33] For this reason, when determining whether to file SARs, a mutual fund generally has to look for more objective "red flags," such as in cases where it has the information on sources of funding for an individual account (*e.g.*, foreign); or for an individual account, failure to respond to information requests or certain pattern activity (*e.g.*, redemptions at certain thresholds following multiple purchases). Further, we understand that the majority of SARs filed by mutual funds involve suspected incidents of fraud.

[34] *See* Frequently Asked Questions, Suspicious Activity Report Requirements for Mutual Funds, FIN-2006-G013 (Oct. 4, 2006), *available at* http://www.fincen.gov/statutes_regs/guidance/pdf/guidance_faqs_sar_10042006.pdf.

With the adoption of the USA PATRIOT Act, mutual funds for the first time became subject to the broad range of AML obligations applicable to financial institutions under the BSA – including, without limitation, AML program obligations, SAR requirements, and CIP obligations. We believe it is significant that the legislative history of the USA PATRIOT Act specifically clarifies that Congress did *not* intend for mutual funds to be subject to beneficial ownership requirements. Specifically, in discussing what would become Section 326 of the USA PATRIOT Act, the relevant House Report states:

> Under this approach, for example, where a mutual fund sells its shares to the public through a broker-dealer and maintains a "street name" or omnibus account in the broker-dealer's name, the individual purchasers of the fund shares are customers of the broker-dealer, rather than the mutual fund. The mutual fund would not be required to "look through" the broker-dealer to identify and verify the identities of those customers. Similarly, 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 would not be required to "look through" the plan to identify its participants.[35]

The language above makes clear that Congress did not intend for mutual funds to obtain beneficial ownership information on their customer relationships. For this reason, we believe that FinCEN must precisely indicate the statutory basis for any beneficial ownership requirements applicable to mutual funds.

In addition, the Treasury Department acknowledged that requiring a financial institution to obtain beneficial ownership information – even for higher risk accounts – was not justified under a cost/benefit analysis. In a 2002 report to Congress, the Treasury Department and the federal financial regulators specifically declined to recommend that certain trusts and corporations organized as "personal holding companies" be required to "disclose their beneficial owners when opening accounts or initiating funds transfers at any domestic financial institution."[36] The regulators recommended no further beneficial ownership reporting requirements for such trusts and corporations, citing the need to ensure "that a balance is struck between the potential for abuse of asset management vehicles, such as

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[35] H.R. Rep. No. 107-250, at 62. Since adoption of the USA PATRIOT Act, the trend toward omnibus account holding has only increased.

[36] A personal holding company, for this purpose, is a "corporation or business or other grantor trust whose assets are predominantly securities, bank certificates of deposit, or other securities or investment instruments (other than those relating to operating subsidiaries of the corporation or trust) and that has 5 or fewer common shareholders or holders of beneficial or other equity interest." USA PATRIOT Act § 356, *codified at* 31 U.S.C. § 5311.

trusts, personal holding companies, and other vehicles, and the limitation and costs resulting from regulatory requirements."[37] FinCEN appears to have changed the position it took in the 2002 report to Congress. We believe it would be helpful for FinCEN to describe its reasons for now believing that requiring beneficial ownership information justifies cost/benefit scrutiny.

2. *Costs of Obtaining Beneficial Ownership Information Substantially Outweighs Its Extremely Limited Utility*

Since it generally is not possible to verify beneficial ownership information, we believe that the costs of obtaining, maintaining, and updating such information substantially outweighs the extremely limited utility of beneficial ownership information. For most entities organized under U.S. law, beneficial ownership information is not publicly available because states largely do not require entities to disclose the identity of their beneficial owners at the time they are incorporated or organized.

As FinCEN is aware, the U.S. Congress is considering the *Incorporation Transparency and Law Enforcement Assistance Act* (the "Incorporation Bill"), which is supported by President Obama's administration.[38] The Incorporation Bill would require states to obtain a list of beneficial owners of most corporations and limited liability companies formed under their laws, and would direct the Government Accountability Office to study beneficial ownership requirements for partnerships and trusts. Until such time as states are required to obtain and verify beneficial ownership information at the time of entity formation, however, it is practicably impossible for mutual funds to reliably verify the accuracy and completeness of beneficial ownership information related to most entities. At best, mutual funds would be able to inquire directly of the individuals opening an account; however, "bad actors" presumably would not be forthright in disclosing their ownership. As a result, we believe that the burden to mutual funds of collecting, maintaining, and updating such information far exceeds any perceived value in the effort to protect the United States financial system from criminal abuse and to guard against terrorist financing, money laundering and other financial crimes.

3. *The ANPRM's Definition of Beneficial Owner is Unworkable*

We have deep concerns with the definition of beneficial owner set forth for legal entities in the ANPRM. We believe the definition is so vague and convoluted that it is exceedingly difficult to utilize

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[37] Report to Congress in Accordance with Section 356(c) of the USA PATRIOT Act (Dec. 31, 2002), *available at* http://www.fincen.gov/news_room/rp/files/356report.pdf.

[38] S. 1483, 112th Cong., 2nd sess.

for CDD purposes, particularly since it would be nearly impossible to explain the definition to customers on account applications. In addition, a vague definition of beneficial owner, such as that set forth in the ANPRM, will lead to inconsistent application and be subject to different interpretations by financial institutions.

The recently revised FATF Recommendations define beneficial owner as the natural person or persons who ultimately own or control a customer and/or the natural person on whose behalf a transaction is being conducted. They also include those persons who exercise ultimate effective control over a legal person or arrangement.[39] In the context of CDD for legal persons, FATF endorses the use of thresholds to identify controlling persons (*e.g.*, 25%).[40] We believe that such thresholds provide a clear and understandable standard for identifying controlling beneficial owners, and have been used for years in the AML regulatory regimes of other FATF member jurisdictions, including in Canada, Australia, and members of the European Union. For example, in Australia, "beneficial owner" is defined, in respect to a company, as any individual who owns through one or more share holdings more than 25% of the issued capital of a company.[41] The 25% threshold is also utilized in Europe.[42] We believe that any definition of "beneficial ownership" should determine beneficial owners of an entity solely on the basis of a clear percentage threshold that investors and mutual funds can readily understand, and not based on potentially subjective determinations of control or levels of responsibility.[43] This approach would be consistent with the definitions used in other FATF-member jurisdictions.

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[39] FINANCIAL ACTION TASK FORCE, FATF RECOMMENDATIONS, Glossary (Feb. 2012).

[40] *Id*. at Interpretive Note to Recommendation 10 (Customer Due Diligence).

[41] *See* Australia Anti-Money Laundering and Counter-Terrorism Financing Rules Instrument 2007 (No. 1), as amended. *See also* Canada Consolidation Proceeds of Crime (Money Laundering) and Terrorism Financing Reporting Regulations, SOR/2002-184, Section 11.1 (information on directors or partners or on persons who own or control 25% or more of a corporation or other entity); and Hong Kong Securities and Futures Commission: Guideline on Anti-Money Laundering and Counter-Terrorist Financing (April 2012) (requiring a firm to identify the beneficial owner of a corporate customer where the beneficial ownership reaches or exceeds 10% and to verify, for all clients, where beneficial ownership reaches or exceeds 25%, and, for high risk clients, where beneficial ownership reaches or exceeds 10%).

[42] *See* Report from the Commission to the European Parliament and Council on the Application of Directive 2005/60/EC on the prevention of the use of the financial system for the purpose of money laundering and terrorist financing (describing the 25% threshold as sufficient to regard a person as a beneficial owners).

[43] The ANPRM's proposed definition describes persons who "directly or indirectly, through any contract, arrangement, understanding, relationship, intermediary, tiered entity, or otherwise, has at least as great an equity interest in the entity as any other individual" and also "the individual with greater responsibility than any other individual for managing or directing the regular affairs of the entity." *See* ANPRM, *supra* note 2, at 13,052.

V. Proposed Approach to Beneficial Ownership Obligations for Mutual Funds

Notwithstanding our strong concerns about the March 2010 Guidance and the description of the "beneficial ownership" component of CDD in the ANPRM, we believe it is reasonable for mutual funds to address in their AML programs the circumstances where a fund will obtain information about beneficial owners under certain circumstances. ICI appreciates that the ANPRM appears to envisage a risk-based approach to obtaining and verifying beneficial ownership information, and the need for FinCEN to exempt certain low-risk customer relationships from beneficial ownership requirements.[44] Accordingly, we believe that any beneficial ownership requirement applicable to mutual funds should include the following elements, which are consistent with a risk-based approach and international AML standards.

A. Treatment of Customers Exempt from CIP Requirements and Omnibus Accounts

Under the CIP rules, a mutual fund is not required to verify the identity of certain readily identifiable customers. These include regulated U.S. financial institutions, U.S. and state government entities, publicly-traded companies, and other low-risk customers.[45] Mutual funds also are not required to verify the identity of customers establishing certain types of accounts, such as accounts opened for the purpose of participating in an employee benefit plan established pursuant to ERISA.[46] The ANPRM requests comment on whether financial institutions, including mutual funds, should be required to obtain and verify beneficial ownership information for customers and accounts that are exempt from CIP requirements ("CIP Exempt Customers").[47]

We believe that mutual funds should not be required to obtain or verify beneficial ownership information for CIP Exempt Customers for several reasons. First, when crafting the exemptions from the CIP rules, FinCEN and the SEC took into account the low money laundering and terrorist financing risks associated with certain types of customer relationships, and determined that mutual funds should not be required to apply their CIP procedures to those relationships. If a customer

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[44] ANPRM, *supra* note 2, at 13,051.

[45] *See* 31 C.F.R. § 1010.100(c)(2).

[46] *See id.* § 1010.100(a)(2).

[47] As noted above, "CIP Exempt Customers" include a financial institution regulated by a federal functional regulator or a bank regulated by a state bank regulator, government agencies and instrumentalities, certain publicly traded companies, accounts opened for the purpose of participating in an ERISA plan, existing accounts and accounts acquired through merger, purchase of assets or other type of reorganization. *See* 31 C.F.R. §§ 1024.100(a)(2), 1024.100(c)(2).

relationship poses low risks for CIP purposes, then it also poses low risks for other purposes – including beneficial ownership purposes.[48]

Second, mutual funds have developed systems to comply with the CIP rules that carve out CIP Exempt Customers from their CIP processes. Requiring mutual funds to obtain and verify beneficial ownership information about CIP Exempt Customers would effectively gut the exemptions in the CIP rules, since it is difficult to imagine how a financial institution could identify and verify a beneficial owner without identifying and verifying the customer (*i.e.,* the named accountholder). If mutual funds are required to identify and verify beneficial owners of CIP Exempt Customers, then they would have to make significant and costly changes to their existing internal controls, systems, processes, and procedures.

Finally, exempting CIP Exempt Customers from beneficial ownership requirements is consistent with the construct of the ANPRM, which envisages that mutual funds would use their CIP processes in obtaining and verifying beneficial ownership information. For example, the ANPRM assumes that mutual funds will use their existing CIP verification processes to verify beneficial owners.[49] Because any beneficial ownership requirement is necessarily intertwined with the CIP rules, a mutual fund should not be required to obtain and verify beneficial ownership information in cases where a customer relationship is exempt from CIP requirements.

In addition, we do not believe that mutual funds should be required to obtain or verify beneficial ownership information in connection with omnibus accounts or "accounts that function in a manner similar to omnibus accounts."[50] In the ANPRM, FinCEN justifies its authority to issue a CDD rule by citing to the AML program requirements applicable to financial institutions – and particularly the requirement that financial institutions have internal controls reasonably designed to prevent the financial institution from being used for money laundering or terrorist financing.[51] As noted above, however, the preamble to the AML program rule for mutual funds makes clear that the rule "does not require that a mutual fund obtain any additional information regarding individual transactions that are

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[48] We note that FinCEN has not alleged or established that CIP Exempt Customers have presented problems.

[49] ANPRM, *supra* note 2, at 13,053 (noting that verification of beneficial owners "would presumably be accomplished by using procedures similar to those currently required pursuant to the CIP Rules").

[50] *See, e.g.*, 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 (noting that accounts established through the NSCC's Fund/SERV system "function in a manner similar to omnibus accounts").

[51] ANPRM, *supra* note 2, at 13,046.

processed through another entity's omnibus account."[52] Because FinCEN previously has recognized that mutual funds are not required to "look through" omnibus accounts in the context of their AML program obligations, we do not believe that mutual funds should be required to "look though" omnibus or similar accounts to identify or verify beneficial owners as part of any CDD rule.

B. Simplified Due Diligence on Relationships Introduced by Other Regulated Entities

ICI firmly believes that mutual funds should be able to apply "simplified due diligence" procedures, as described below, in connection with customer relationships introduced by certain regulated intermediaries, so long as a financial institution determines that the use of simplified due diligence is reasonable under the circumstances. Such simplified due diligence procedures would require a mutual fund to comply with its CIP obligations and monitor account activity, but would not require a mutual fund to identify or verify beneficial ownership information.

Almost every jurisdiction that has adopted detailed CDD regulations with beneficial owner requirements – along the lines envisaged by the ANPRM – has also acknowledged that financial institutions must be allowed to apply some form of simplified due diligence in cases where a customer relationship is introduced by qualified third parties under appropriate circumstances. We therefore propose that a mutual fund should be able to apply such an approach and rely on CDD – including with respect to beneficial ownership information – that is performed by a financial institution regulated in a FATF member jurisdiction.

Notably, the simplified due diligence procedures we envisage here are different from the concept of "reliance" in the CIP rule. Under the CIP rule, a financial institution may rely on CIP performed by other U.S. regulated financial institutions if certain conditions are met, in which case the relying financial institution is not legally responsible for CIP.[53] For CDD purposes, we envisage a more simplified level of due diligence where a mutual fund could acknowledge and rely on the CDD already performed on a customer relationship by a broader universe of financial entities –any financial institution subject to functional regulation in a FATF member jurisdiction. Consistent with international norms, however, the mutual fund using simplified due diligence would remain ultimately responsible for ensuring that its overall CDD obligations are met, and that the use of simplified due diligence is reasonable under the circumstances.[54]

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[52] Mutual Fund AML Program Rule, *supra* note 12, at 21,120.

[53] 31 C.F.R. § 1010.220(a)(6).

[54] *See, e.g.,* Joint Money Laundering Steering Group (UK), Guidance Notes for the Financial Sector § 5.6.4.

C. Guidance on Other Low Risk Entities

The ANPRM notes that FinCEN will provide guidance about other types of low risk entities that would be exempt from beneficial ownership requirements as part of CDD.[55] As part of this process, we request that FinCEN consider excluding additional low risk customer relationships from beneficial ownership requirements, including but not limited to:

- a qualified retirement account (whether or not established pursuant to ERISA);
- regulated, non-U.S. funds and other financial institutions; and
- entities that are part of the same corporate group as a financial institution.

In addition, we believe it is essential for FinCEN to take the position that any list of entities exempt from beneficial ownership requirements is not exhaustive. Consistent with a risk-based approach, a mutual fund should have the flexibility to determine whether a customer relationship poses lower risks that warrant more simplified due diligence measures.

D. Beneficial Ownership Approach to Other Relationships

For higher risk customer relationships, we believe it is reasonable for mutual funds to address in their AML programs the circumstances where a fund will obtain information about beneficial owners. However, mutual funds should have the flexibility to determine the circumstances under which beneficial ownership information would be obtained – based on the nature of a fund, the extent to which it is sold through regulated third parties, the fund's customer base, and other relevant factors. This flexible approach is consistent with the approach taken in the AML program rule and the preamble to that rule, which states that "[b]ecause mutual funds operate through a variety of different business models, one generic anti-money laundering program for this industry is not possible; rather, each mutual fund must develop a program based upon its own business structure."[56]

For example, a mutual fund may determine to obtain beneficial ownership information when it establishes a direct customer relationship with an offshore trust, private investment company, or similar entity formed under the laws of a jurisdiction with an underdeveloped AML regulatory regime. Similarly, a mutual fund may determine to obtain beneficial ownership information when establishing a

[55] ANPRM, *supra* note 2, at 13,051 ("FinCEN anticipates that it would provide additional guidance regarding customers that may be considered low risk (and therefore exempt for purposes of this beneficial ownership requirement)").

[56] Mutual Fund AML Program Rule, *supra* note 12, at 21,119.

direct relationship with a senior non-U.S. political figure, even if not required to do so. In addition, a mutual fund may obtain additional information about its customer relationships – including beneficial ownership information – if such information is necessary to comply with non-BSA regulatory obligations, or is otherwise required by the fund's compliance policies and procedures.[57]

As described above, to the extent that any CDD rule requires mutual funds to verify the disclosed identities of beneficial owners of a legal entity, the requirement should closely track a mutual fund's existing obligations under the CIP rules. To that end, the identification information that is required from beneficial owners should be similar to the identification information that is currently required under the CIP rules (*i.e.*, name, address, date or birth and identification number), and mutual funds should be asked only to verify the *identity* of beneficial owners – by documentary or non-documentary means, consistent with the Mutual Fund CIP Rule – as opposed to verifying an individual's *status* as a beneficial owner. Moreover, mutual funds should only have to identify and verify the identity of beneficial owners at the time of account opening.

VI. Conclusion

For the reasons noted above, we have strong concerns about the concept of CDD, and particularly beneficial ownership obligations, as described in the ANPRM. Notwithstanding our concerns about the ANPRM, however, our members remain committed to working with FinCEN to help protect the U.S. financial system from money laundering, terrorist financing and other illicit activities. To this end, we are committed to working with FinCEN and the SEC to develop a tailored CDD rule that would be effectively applied to mutual funds and reflects their unique shareholder servicing model.

[57] For example, under Rule 22c-2, a mutual fund may request that financial intermediaries provide the fund with the taxpayer identification number (and certain other identifying information) of certain shareholders that have transacted with the fund through a financial intermediary. *See* 17 C.F.R. § 270.22c-2(a)(2)(i), (c)(5); Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings, Securities Act Release No. 8,048 (Apr. 16, 2004).

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We appreciate the opportunity to express our views on the ANPRM. If you have any questions about the matters discussed in this letter, please contact Karrie McMillan (at 202-326-5815 or kmcmillan@ici.org), Susan Olson (at 202-326-5813 or solson@ici.org) or Eva Mykolenko (emykolenko@ici.org or 202-326-5837).

Sincerely,

/s/ Karrie McMillan

Karrie McMillan
General Counsel

cc: Diane C. Blizzard, Associate Director for Regulatory Policy and Investment Adviser Regulation
Division of Investment Management
U.S. Securities and Exchange Commission

APPENDIX A

Mutual Funds, Intermediaries and Owners of Fund Shares

This Appendix generally describes mutual fund distribution, transactions in mutual funds and how information moves between shareholders, financial intermediaries and mutual funds. In general, shareholders may interact with a mutual fund either directly with the fund's transfer agent[1] or indirectly typically after consulting with a financial representative who works for, or processes trades through, an intermediary.[2] Investors choose which intermediary best suits their needs.[3]

Today, most mutual fund shareholders do not purchase their shares directly from a mutual fund company. ICI research shows that 69 percent of mutual fund-owning households own mutual funds through an employer-sponsored retirement plan and 80 percent of investors who own mutual funds outside of such a plan purchased their shares through an intermediary such as a broker-dealer, a bank trust department, or an insurance company.[4] The substantial majority of mutual fund assets are held through retirement plans and intermediaries.

The information available to a fund about its underlying investors is directly affected by the intermediaries and the account arrangements through which the shareholder's purchases and

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[1] For individual customer accounts established directly with the fund, the fund transfer agent maintains records of accounts, calculates and distributes dividends and capital gains, and prepares and mails account statements confirming transactions and account balances, federal income tax information, and other shareholder notices. Some transfer agents also maintain customer service departments, including call centers, to respond to shareholder inquiries. For omnibus accounts and individual accounts controlled exclusively by an intermediary, the intermediary provides to the investor the following: trade confirmations, statements, and investment information; any tax reporting; and required shareholder communication. *See* Appendix B, Intermediary Paper (describing account structures, processing and information on the books of the intermediary and the fund's transfer agent for different account structures).

[2] Intermediaries may include broker-dealers, banks, investment advisors, insurance companies, and financial planners.

[3] Investors use intermediaries to obtain a number of benefits. Intermediaries can be a single point of contact for financial planning expertise and other services and also may provide access to an array of investment choices, *e.g.*, stocks, bonds, mutual funds, annuities. There are also a variety of intermediary service models. *See* Why Do Mutual Fund Investors Use Professional Financial Advisers, ICI Research Fundamentals, Volume 16, No. 1 (April 2007) available at http://www.ici.org/pdf/fm-v16n1.pdf.

[4] *See* "Rulemaking Must Reflect Realities of Funds' Access to Shareholder Information," *ICI Viewpoint,* available at http://www.ici.org/viewpoints; and "Profile of Mutual Fund Shareholders, 2011," *ICI Research Report* (February 2012), available at http://www.ici.org/pdf/rpt_12_profiles.pdf.

redemptions are transmitted to the mutual fund. Mutual funds and intermediaries have different information and different obligations, depending both on their relationships and how the shareholder interacts with the fund.[5]

A. Account Structures Used by Mutual Funds

A fund's shareholder is the person or entity that opens an account directly with the fund and whose name is on the fund's records. Two account arrangements are used by mutual funds: individual and omnibus. Typically the intermediary determines which account structure it will use for its mutual fund business. Funds generally need to be prepared to provide the appropriate support for whichever account the intermediaries choose to use.

Individual accounts are held either in the name of the investor or in the name of an intermediary (for the benefit of the investor who is the intermediary's customer). For individual accounts held in the name of the investor, the fund knows the shareholder's identity and entire transactional history. For individual accounts opened and held in the name of an intermediary, the fund knows the shareholder's transactional history,[6] but may or may not know the shareholder's identity.[7]

An omnibus account is held in the name of an intermediary and represents the accounts of multiple investors that are customers of the intermediary. For omnibus accounts, the fund's recordkeeper does not know the individual identities of the underlying shareholders; it knows only the intermediary

[5] Each fund decides which intermediaries, if any, to do business with to reach investors. The intermediary, its business model, and the types of services offered by an intermediary all influence the relationship between the fund and the intermediary. To effect that relationship, the fund and the intermediary execute a contract that spells out the obligations of each party. In the United States, most intermediaries are independent from the funds they sell and therefore the funds have limited input on how the intermediary's client is serviced. Aside from any contractual or prospectus obligations related to selling fund shares, the intermediary establishes its own business model, processing and procedural routines, computer systems, vendors, and target market. The constraints for the intermediary include legal, regulatory, and contractual requirements, as well as competitive market forces.

[6] In some cases, adjustments or corrections to the shareholder's transaction history that are made by the intermediary may cause the individual transaction history in the fund's records to differ from the intermediary's records. The shareholder's balance, however, remains the same.

[7] Even if the fund knows the shareholder's identity, the fund may have varying amounts (from none to some) of other investor information.

acting on behalf of the intermediary's clients. The fund's recordkeeper knows the transactional history for the omnibus account as a whole, but does not know an individual transaction history for each underlying shareholder for whom transactions are typically aggregated and transmitted by the intermediary via the omnibus account. Some omnibus accounts may contain only a specific type of account. For example, a bank may open an omnibus account to aggregate all customer accounts that have chosen the same dividend reinvestment option, or an omnibus account may be opened for a single retirement plan. In other cases, an omnibus account could represent a mix of the intermediary's customers, from individual investors, retirement plans and other pooled accounts.[8]

A significant trend in customer recordkeeping by intermediaries is the shift away from intermediary controlled individual accounts to omnibus account structures. This trend is noticeably reducing the number of individual accounts on a fund's books and also reducing the amount and type of information that funds have regarding underlying shareholders.[9]

B. Activities Through the DTCC

For many mutual funds, transactions that occur through intermediaries are processed through the industry utility provided by the Depository Trust and Clearing Corporation ("DTCC"). The DTCC has two services through its subsidiary, the National Securities Clearing Corporation ("NSCC"), for mutual fund clearance and settlement: Fund/SERV[10] and Networking.[11] These automated services for DTCC participants provide secure, efficient, and cost-effective trading, money settlement, and information exchange through dedicated system connections using standardized formats and procedures. Because these systems employ established requirements, timeframes are set so a sender and a receiver know the parameters for exchanging trade and account-related information. Knowing the

[8] These heterogeneous omnibus accounts are sometimes referred to as "super" omnibus accounts.

[9] Recent statistics provided by the Depository Trust and Clearing Corporation show over the past year approximately a 24% decline in the number of intermediary controlled individual accounts, from approximately 67 million accounts in February 2011 to 51 million accounts as of February 2012, primarily due to omnibus account conversions.

[10] Fund/SERV provides a standardized and fully automated platform to process purchase, exchange, and redemption orders, and to settle those orders.

[11] Networking supports the exchange and reconciliation of account information as held on the books of the transfer agent with that held on the books of the intermediary.

established requirements and timeframes enables both sides to create control points for receipt of data and exception processing for missing data. Both omnibus and individual account transactions are processed through the NSCC.

1. Individual Accounts through the DTCC

The most common type of individual networked accounts opened and processed through the NSCC are controlled exclusively by an intermediary for the benefit of a single customer. The shareholder's identity may be fully, partially, or not disclosed on the fund's account record that is registered in the intermediary's name for the benefit of the investor. The intermediary supports all of the functions necessary for these accounts and exclusively controls the relationship with its customer.[12]

2. Omnibus Accounts through the DTCC

For omnibus accounts, the account is opened on the records of the fund in the name of the intermediary, and includes the shares of multiple investors in that fund who are customers of the intermediary. In most cases, transactions in the omnibus account are consolidated by the intermediary for all of its customers that are purchasing or redeeming shares of the same fund that day into one or a few "summary" transactions to be processed through the NSCC with the fund. The fund does not have information on its transfer agent recordkeeping system related to the underlying investors or beneficial owners of the shares represented in the omnibus account. The intermediary manages the interactions with the investors whose shares are held in the omnibus account and provides all of the related support services, including tax reporting.

C. Activities Directly with the Mutual Fund

Transactions conducted directly with mutual funds may occur over the internet, by telephone, or through the mail. Generally, individual shareholders initiate these transactions; in certain circumstances, an intermediary may be managing or is associated with the direct account at the fund.[13]

[12] In some instances, broker-dealers or other intermediaries will provide some shareholder services on individual accounts, such as processing trades and providing statements, while the fund provides other shareholder services, such as investor accounting and tax reporting. In these instances, the investor may interact with either the intermediary or the fund, or both.

[13] For example, an investor may open an account through an intermediary where the intermediary mails an account application and a check typically to the fund transfer agent. In this situation, the account is opened in the name and tax

For accounts held directly with the mutual fund, shareholder servicing (including tax reporting) is conducted by the mutual fund transfer agent.

identification number of the investor and the fund complex is the primary point of contact for the investor, including for tax reporting.

Appendix B

Letter from Investment Company Institute, Securities Industry and Financial Markets Association, and Futures Industry Association to Financial Crimes Enforcement Network and Securities and Exchange Commission, dated June 2010, 2010 (following).

June 9, 2010

Mr. James H. Freis, Director
Mr. Jamal El-Hindi, Associate Director for Regulatory Policy and Programs
Financial Crimes Enforcement Network
Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, DC 20220

Ms. Lourdes Gonzalez
Mr. John J. Fahey
Ms. Emily Westerberg Russell
Office of the Chief Counsel
Division of Trading and Markets
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549

Ladies and Gentlemen:

The Investment Company Institute, the Securities Industry and Financial Markets Association, and the Futures Industry Association (the "Associations")[1] have been carefully evaluating the March 5, 2010 *Guidance on Obtaining and Retaining Beneficial Ownership Information* (the "*Guidance*").[2] The Associations and their members strongly support the efforts of the Financial Crimes Enforcement Network ("FinCEN") and the Securities and Exchange Commission ("SEC") to encourage financial institutions to implement robust, risk-based anti-money laundering ("AML") compliance programs. As discussed below, however, we have three fundamental concerns with the *Guidance*.

- First, we are concerned about the statement in the *Guidance* that "customer due diligence" ("CDD"), as described in the *Guidance*, represents an "existing regulatory expectation[]" previously communicated by the regulators to securities and futures firms. In fact, until earlier this year, only the federal banking regulators had published their CDD expectations, as set forth in the Federal Financial Institutions Examination

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1 The Investment Company Institute (ICI) is the national association of U.S. investment companies. The Securities Industry and Financial Markets Association (SIFMA) brings together the shared interests of more than 600 securities firms, banks and asset managers. The Futures Industry Association (FIA) is a principal spokesperson of the commodity futures and options industry.

2 *Guidance on Obtaining and Retaining Beneficial Ownership Information*, FinCEN Guidance, FIN-2010-G001 (Mar. 5, 2010).

Council's Bank Secrecy Act/Anti-Money Laundering Examination Manual (the "Bank Manual").[3] We do not believe that the Bank Manual is an appropriate vehicle to provide guidance about Bank Secrecy Act ("BSA") expectations to securities and futures firms not subject to examinations under the Bank Manual.

- Second, the expectations in the *Guidance* relating to the collection and verification of beneficial ownership information as part of CDD conflict with the approach to beneficial ownership set forth in the BSA, and are impracticable. Among other things, we believe it is practically impossible for financial institutions to "verify beneficial owners," as the *Guidance* suggests, given that most entities organized under U.S. law are not required to disclose information about their beneficial owners.

- Finally, we observe that the *Guidance* – and particularly the description of "enhanced due diligence" ("EDD") in the *Guidance* – includes many of the same concepts that appear in rules that require certain financial institutions to conduct due diligence on certain private banking accounts and correspondent accounts maintained for non-U.S. persons.[4] To the extent the *Guidance* was designed to apply elements of these rules to *all accounts* maintained by financial institutions, we strongly believe that such action may be done only through formal rulemaking, with the opportunity for public comment and after a thorough cost/benefit analysis.[5]

Representatives of our Associations and their member firms have raised these concerns with representatives from FinCEN, the SEC and the Commodity Futures Trading Commission ("CFTC"), and were encouraged to put these concerns in writing in order to begin a dialogue about how best to move forward. As discussed below, we request a meeting with representatives from FinCEN, the SEC and the CFTC to address the need for separate, revised guidance that is appropriately tailored to the specific and varied operations of securities and futures firms.[6] Until such further guidance is provided, we request that you advise relevant inspections and examinations staff that our member firms are not required to follow the specific CDD and beneficial ownership requirements set forth in the *Guidance*.

I. Customer Due Diligence

The term "Customer Due Diligence" does not appear in the BSA or the regulations thereunder.[7] It is not used in the preambles to the proposed or final rules requiring financial institutions to implement AML programs, file suspicious activity reports ("SARs"), or verify the identity of

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[3] Federal Financial Institutions Examination Council, *Bank Secrecy Act / Anti-Money Laundering Examination Manual* (Apr. 29, 2010).

[4] *See* 31 C.F.R. §§ 103.178(b)(1) ("Private Banking Account Rule"), 103.176 ("Correspondent Account Rule").

[5] Administrative Procedure Act, 5 U.S.C. §§ 500 *et seq.*

[6] The Associations also consulted with the American Council of Life Insurers, which concurred with our request for additional, industry-specific guidance to the extent that the *Guidance* was intended to apply to the activities of life insurers.

[7] 31 U.S.C. §§ 5311 *et seq.*; 31 C.F.R. §§ 103.11 *et seq.*

their customers.[8] FinCEN has adopted specific rules requiring financial institutions to conduct due diligence on accounts established or maintained for certain foreign persons, but these rules apply only to "correspondent accounts" maintained for foreign financial institutions, and to "private banking accounts" maintained for certain foreign persons.[9] While the CDD concept is embodied in Recommendation 5 of the FATF's Forty Recommendations, FATF recommendations are not enforceable on U.S. financial institutions unless and until they are implemented by the United States. The FATF itself has observed that Recommendation 5 has never been implemented fully by the United States.[10]

Prior to the publication of the *Guidance*, the primary official pronouncement of the regulators' CDD expectations appeared in the Bank Manual, first published in June 2005. The *Guidance* acknowledges that the Bank Manual "is issued by the federal banking regulators regarding AML requirements applicable to banks," but states that "it contains guidance that may be of interest to securities and futures firms."

We do not believe that the Bank Manual is an appropriate vehicle to provide guidance to securities and futures firms not subject to examinations under the Bank Manual. The Bank Manual describes how the federal banking regulators will inspect banks not only for compliance with their obligations under the BSA, but also to ensure that banks are not engaging in unsafe or unsound practices in violation of specific banking regulations not applicable to securities and futures firms.[11] It is prepared by the federal banking regulators, and is tailored to the specific operations of the banking industry. For example, it addresses how banks should incorporate various BSA obligations in traditional banking functions such as lending activities, bulk shipments of currency, pouch activities, ATM transactions, and other functions not germane to securities and futures firms.

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8 *See generally* 31 U.S.C. §§ 5318(g), (h), and (l) and the regulations thereunder.

9 *See generally id.* §§ 5318(i), (j), and (k) and the regulations thereunder.

10 *Financial Action Task Force*, *Summary of the Third Mutual Evaluation Report on Anti-Money Laundering and Combating the Financing of Terrorism* (June 23, 2006), at 299 ("FATF Report"). The CDD section of the FATF Report states that there is "[n]o explicit obligation to conduct ongoing due diligence" under United States law except in certain defined circumstances (*e.g.*, foreign correspondent and private banking accounts). While the FATF report notes that "[t]he U.S. authorities interpret the suspicious activity reporting obligations as necessarily requiring institutions to have policies and procedures in place to undertake ongoing due diligence generally," as noted above, the term "customer due diligence" is not mentioned in the SAR rules or the preambles to the SAR rules. The FATF Report concluded the United States had not fully incorporated CDD into its AML/CFT regime, and recommended that the United States "[i]ntroduce an explicit obligation that financial institutions should conduct ongoing due diligence." To date, however, the United States has not adopted a law or regulation requiring financial institutions to implement CDD processes.

11 The Bank Manual notes, for example, that CDD processes can aid in allowing a bank to "adhere to safe and sound banking practices." *See* Bank Manual, *supra* note 3, at 63. For an overview of the federal banking regulators' expectations relating to unsafe and unsound practices, *see* Section 15.1 of the FDIC's Risk Management Manual of Examination Policies, *available at* http://www.fdic.gov/regulations/safety/manual/index.html.

Because the Bank Manual does not provide specific guidance relevant to the unique and varied customer types, products and services of securities and futures firms, we do not believe it is appropriate to expect these financial institutions to look to the Bank Manual for guidance about their obligations under the BSA, including with respect to CDD.[12] Rather, as discussed below, we would welcome the opportunity to work with you to develop CDD guidance that is appropriately tailored to the customer types, products and services of securities and futures firms.

II. Beneficial Ownership

We also are concerned that the expectations in the *Guidance* relating to the collection and verification of beneficial ownership information as part of CDD are impracticable, and conflict with the approach to beneficial ownership taken by the BSA and the regulations thereunder.

A. The *Guidance* Conflicts with the Treatment of Beneficial Ownership Under the BSA Regulations

1. The BSA Regulations Do Not Require Financial Institutions to Verify the Identity of Beneficial Owners

The *Guidance* states that a financial institution's CDD procedures should be "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." This approach is inconsistent with existing law. While the BSA regulations require financial institutions to identify and verify the identity of their customers, they generally do not require financial institutions to identify and verify the identity of beneficial owners. The 2003 rules that require financial institutions to verify the identity of their customers generally allow financial institutions to treat the named accountholder as their "customer."[13] FinCEN and the federal financial regulators initially had proposed to require financial institutions to both "identify" and "verify the identity" of "any person authorized to effect transactions in a customer's account," but that proposal was not adopted. Instead, the final rules only require financial institutions to "obtain information" about persons with authority or control over accounts for customers that are not individuals, and only in those cases where a financial institution is not able to verify the "true identity" of the customer.[14] Moreover, the final rules dropped the proposal for financial

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[12] Although the Financial Industry Regulatory Authority ("FINRA") published a "Small Firm Template" in January 2010 that suggests CDD policies and procedures for small broker-dealers, the Small Firm Template itself notes that CDD "is not specifically required by the AML rules," and that "nothing in [the Small Firm Template] creates any new requirements for AML programs." FINRA, AML Small Firm Template, *available at* http://www.finra.org/Industry/Issues/AML/p006340. The Small Firm Template is not designed to extend regulatory requirements to broker-dealers – particularly to large broker-dealers for which the Small Firm Template is not designed. Moreover, the CDD section was added to the Small Firm Template and was published without any notice to, or input from, the broker-dealer community. The description of CDD in the Small Firm Template also appears to be lifted largely from the Bank Manual, and is not appropriately tailored to the securities industry. For these reasons, we strongly believe it needs to be reconsidered.

[13] *See* 31 C.F.R. §§ 103.121, 103.122, 103.123, and 103.131.

[14] *See, e.g., id.* § 103.131(b)(2)(ii)(C).

institutions to "verify the identity" of such persons. Accordingly, while a financial institution may request additional information about persons with authority or control over certain high risk accounts opened by persons other than individuals, the BSA regulations do not require financial institutions to "verify the identity" of beneficial owners of an account, as the *Guidance* suggests.

2. The BSA Regulations Require Financial Institutions to Obtain Beneficial Ownership Information Only for Certain High Risk Foreign Accounts

The BSA regulations do require certain financial institutions to obtain information about beneficial ownership, but only with respect to certain high risk accounts maintained for foreign persons.[15]

- Under the Private Banking Account Rule, certain financial institutions are required to obtain beneficial ownership information, but only with respect to an account that: (i) requires a minimum aggregate deposit of funds or other assets of not less than $1,000,000; (ii) is established to benefit one or more non-U.S. persons who are direct or beneficial owners of the account; and (iii) is assigned to, or is administered or managed by, an individual acting as a liaison between the financial institution and the direct or beneficial owner of the account.[16] The Private Banking Account Rule does not require financial institutions to verify beneficial ownership.

- Under the Correspondent Account Rule, certain U.S. financial institutions are required to conduct due diligence on correspondent accounts maintained in the United States for foreign financial institutions. However, these U.S. financial institutions are only required to obtain beneficial ownership information about certain high risk foreign banks subject to EDD.[17] These high risk foreign banks are: (i) banks that operate under an offshore banking license; (ii) banks that operate under a banking license issued by a country designated as a "non-cooperative country or territory" by the FATF; and (iii) banks that operate under a license issued by a jurisdiction designated as warranting "special measures" pursuant to Section 311 of the USA PATRIOT Act. The Correspondent Account Rule does not otherwise require financial institutions to obtain information about beneficial ownership or verify beneficial ownership.

In addition, the BSA authorizes the Secretary of the Treasury to require domestic financial institutions to take certain specified "special measures," including requiring financial institutions "to obtain and retain information concerning the beneficial ownership of any account opened or maintained in the United States by a foreign person," if the Secretary determines that a foreign

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15 *Id.* §§ 103.178(b)(1), 103.176. In addition, if a U.S. bank or broker-dealer maintains a correspondent account in the United States for a foreign bank, the U.S. bank or broker-dealer is required to obtain information about the owners of the foreign bank. *Id.* § 103.177(a)(2).

16 *Id.* § 103.175(o).

17 As part of the EDD process, financial institutions must identify each owner of the foreign bank (if the bank is not publicly traded), as well as each owner's ownership interest. Financial institutions also must identify "any person with authority to direct transactions through any correspondent account that is a payable-through account, and the sources and beneficial owner of funds or other assets in the payable-through account."

financial institution or foreign financial account poses a "primary money laundering concern."[18] For this purpose, the Secretary of the Treasury is required to issue regulations defining "beneficial ownership," which such regulations "shall address issues related to an individual's authority to fund, direct, or manage the account … and an individual's material interest in the income or corpus of the account, and shall ensure that the identification of individuals … does not extend to any individual whose beneficial interest in the income or corpus of the account is immaterial."[19] While the Secretary of the Treasury has invoked this statute to determine that certain foreign financial institutions pose a "primary money laundering concern," the Secretary has not required domestic financial institutions to obtain additional information about beneficial ownership as a "special measure" under this authority, nor has the Treasury defined "beneficial ownership" for this purpose.

Accordingly, the BSA and the regulations thereunder require financial institutions to obtain beneficial ownership information only with respect to certain high risk foreign accounts. In contrast, the *Guidance* envisages that financial institutions should obtain, and verify, beneficial ownership information across a significantly broader range of accounts – domestic and foreign – in order to determine *whether* a customer relationship poses greater risks.[20] We do not see any basis in the BSA for such a requirement. Indeed, in a 2002 report to Congress, the Treasury Department and the federal financial regulators specifically declined to recommend that certain trusts and corporations organized as "personal holding companies" be required to "disclose their beneficial owners when opening accounts or initiating funds transfers at any domestic financial institution."[21] The regulators recommended no further beneficial ownership reporting requirements for such trusts and corporations, citing the need to ensure "that a balance is struck between the potential for abuse of asset management vehicles, such as trusts, personal holding companies, and other vehicles, and the limitation and costs resulting from regulatory requirements."[22]

B. Financial Institutions Do Not Have the Ability to Verify Beneficial Owners of Entities Organized Under U.S. Law

We also are concerned that financial institutions do not have the ability to reliably "verify" beneficial ownership, as described in the *Guidance*. The United States generally does not require

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18 31 U.S.C. §§ 5318A.

19 *Id.* § 5318(e)(3).

20 For example, the *Guidance* states that "[w]here the customer is a legal entity that is not publicly traded in the United States, such as an unincorporated association, a private investment company (PIC), trust or foundation," a financial institution should obtain "information about the structure or ownership of the entity *so as to allow* the institution to determine whether the account poses heightened risk" (emphasis added).

21 A personal holding company, for this purpose, is a "corporation or business or other grantor trust whose assets are predominantly securities, bank certificates of deposit, or other securities or investment instruments (other than those relating to operating subsidiaries of the corporation or trust) and that has 5 or fewer common shareholders or holders of beneficial or other equity interest." USA PATRIOT Act § 356(c)(4).

22 Report to Congress in Accordance with Section 356(c) of the USA PATRIOT Act (Dec. 31, 2002).

entities to disclose the identity of their beneficial owners at the time they are incorporated or organized. Without access to this information, it is impossible for financial institutions to reliably obtain and verify information about the beneficial owners of most entities organized under U.S. law.

The U.S. Congress is considering S. 569, the *Incorporation Transparency and Law Enforcement Assistance Act* (the "Incorporation Bill"), which is supported by President Obama's administration.[23] The Incorporation Bill would require states to obtain a list of beneficial owners of most corporations and limited liability companies formed under their laws, and would direct the Government Accountability Office to study beneficial ownership requirements for partnerships and trusts. Until there is a mechanism for financial institutions to reliably obtain and verify information about the beneficial ownership of entities formed under U.S. law, it is impossible for U.S. financial institutions to "verify" beneficial ownership information for most domestic entities.[24]

C. The Regulators Recently Criticized the "Ambiguity and Breadth" of the "Beneficial Owner" Concept Used in the *Guidance*

We also have concerns about the lack of a reasonable definition of "beneficial owner" in the *Guidance*. The *Guidance* does not define "beneficial owner," but rather states that the definition in the Private Banking Account Rule "may be useful for purposes of this [*Guidance*]."[25] Yet only six months ago, the Treasury Department criticized the "ambiguity and breadth" of what is, in essence, the same definition of "beneficial owner" in the Incorporation Bill, stating that the definition "will make compliance uncertain, time-consuming, and costly."[26] The expectation in the *Guidance* that financial institutions will identify and verify "beneficial owners," by reference to the definition of that term in the Private Banking Account Rule, cannot be reconciled with the Treasury Department's criticism of the definition of "beneficial owner" in the Incorporation Bill.

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23 S. 569, 111th Cong., 1st Sess.

24 The *Guidance* also suggests that a financial institution may share "beneficial ownership information across business lines, separate legal entities within an enterprise, and affiliated support units." We note that certain U.S. federal and state laws, as well as a financial institution's own internal policies, may restrict the financial institution's ability to share beneficial ownership information with affiliated companies. We believe it is appropriate for a financial institution to share beneficial ownership information on an enterprise-wide basis only if such action is consistent with applicable law and the financial institution's privacy policies.

25 *See* 31 C.F.R. § 103.175(b).

26 At hearings on the Incorporation Bill on November 5, 2009, David Cohen, Assistant Secretary of the Treasury for Terrorist Financing, stated that:

> Under S. 569 as currently drafted, the ambiguity and breadth of the definition of beneficial ownership, coupled with burdensome disclosure requirements, makes compliance uncertain, time consuming and costly. The definition and application of beneficial ownership information requirements should be sufficiently straightforward and simple in application to work for the full range of covered legal entities – from small, start-up businesses to large, complex legal entities – and regardless of whether the applicant is a foreign or U.S. person.

III. "Enhanced Due Diligence" and Related Concepts in the Private Banking and Correspondent Account Rules

Finally, we observe that the *Guidance* – and particularly the description of EDD in the *Guidance* – includes many of the same concepts that appear in the Private Banking Account Rule and Correspondent Account Rule. For example, the *Guidance* states that information obtained as part of CDD and EDD should be used to identify any discrepancies between an account's intended purpose and activity and the actual sources of funds and account use – a directive that also appears in the Private Banking Account Rule and Correspondent Account Rule.[27] If the intent of the *Guidance* was to apply elements of the Private Banking Account Rule or Correspondent Account Rule to all accounts maintained by a financial institution, then we strongly believe that such action may be done only through formal rulemaking, with the opportunity for public comment and after a thorough cost/benefit analysis.

IV. Request for Additional Guidance Tailored to Securities and Futures Firms

The Associations strongly support the efforts of FinCEN and the SEC to provide meaningful BSA guidance to financial institutions. However, for the reasons discussed above, we have significant concerns that the *Guidance* does not reflect the current BSA requirements of securities and futures firms, and is not appropriately tailored to the specific customer types, products and services of such financial institutions. We therefore request a meeting with representatives from FinCEN, the SEC and the CFTC to begin a dialogue about providing separate, revised guidance to securities and futures firms. Until such further guidance is provided, we request that you advise your relevant inspections and examinations staff that our member firms are not required to follow the specific CDD and beneficial ownership requirements set forth in the *Guidance*.

We look forward to discussing with you the following concepts, which we believe should be addressed in the revised guidance.

- **Tailored to Securities and Futures Firms.** The revised guidance should be appropriately tailored to the customer types, products and operations of securities and futures firms. For example, it should clearly define what is meant by CDD, and set forth how it should be implemented by securities and futures firms. These firms collectively service tens of millions of accounts, largely on an intermediated basis, where many firms either have no direct contact or very limited direct contact with their customers. The revised guidance should acknowledge the different CDD risks associated with servicing different types of customer bases (*e.g.*, institutional vs. retail accounts), and different types of accounts within those customer bases. It also should acknowledge the necessity for these firms to rely on CDD performed by intermediaries or others with direct contact with the customer,[28] and be consistent with guidance previously provided by the regulators under other BSA regulations.[29]

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27 31 C.F.R. § 103.178(b).

28 *See, e.g.*, FATF Recommendation 9, which states that "[c]ountries may permit financial institutions to rely on intermediaries or other third parties to perform elements … of the CDD process." In accordance with this recommendation, it is common throughout the European Union, and most other FATF member jurisdictions, for financial institutions to rely on CDD performed by "eligible introducers" – which are typically regulated intermediaries that have a direct relationship with the customer. We believe it is vitally important for any future CDD guidance to

- **Use of Beneficial Ownership Information.** The revised guidance should acknowledge that financial institutions currently are not *required* to obtain beneficial ownership information as part of their due diligence or EDD processes, except insofar as required by the Private Banking Account Rule or the Correspondent Account Rule. It should make clear that financial institutions that nonetheless determine to obtain beneficial ownership information about higher risk customer relationships may do so using a risk-based approach. Financial institutions also should not be expected to "verify" such information given that U.S. entities generally are not required to disclose their beneficial owners.

- **Time to Implement CDD Processes.** Because the regulators have not previously communicated their CDD expectations to securities and futures firms, they should be afforded sufficient time to develop CDD processes they have deemed necessary and appropriate for their businesses, to upgrade and enhance systems as necessary to implement these processes, and train appropriate employees on the specific elements of their CDD processes.

- **Application to Certain Financial Institutions.** Finally, financial institutions that are not currently required to verify the identity of their customers under Section 326 of the USA PATRIOT Act, or to conduct due diligence on foreign accounts under Section 312 of the USA PATRIOT Act – such as life insurance companies – also should not be subject to CDD requirements. The Bank Manual notes that CDD "*begins with verifying the customer's identity* and assessing the risks associated with that customer." Financial institutions that are not required to verify the identity of their customers lack an essential element necessary for the development of an effective CDD program, and may not have the infrastructure necessary to integrate CDD into their AML programs.

We fully support the efforts of FinCEN and the federal financial regulators to assist financial institutions in developing and implementing appropriate AML compliance programs. We appreciate your consideration of our requests, and look forward to working with you on appropriate, risk-based CDD and beneficial ownership guidance tailored to the specific customer types, products and services of our member firms.

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acknowledge the need for financial institutions to rely on CDD performed by other regulated third parties.

[29] For example, pursuant to guidance issued under the customer identification program rule for broker-dealers and rules implementing Section 312 of the USA PATRIOT Act, a clearing firm generally is not required to verify the identity of customers introduced by introducing broker-dealers, and generally is not required to apply correspondent account or private banking account due diligence on introduced accounts. *See* Customer Identification Program Rule No-Action Position Respecting Broker-Dealers Operating Under Fully Disclosed Clearing Arrangements According to Certain Functional Allocations, FinCEN Guidance, FIN-2008-G002 (Mar. 4, 2008); Application of the Regulations Requiring Special Due Diligence Programs for Certain Foreign Accounts to the Securities and Futures Industries, FinCEN Guidance, FIN-2006-G009 (May 10, 2006). Similarly, a clearing firm should not be expected to conduct CDD on customers introduced by introducing broker-dealers.

Sincerely,

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