NEW ANTI-MONEY LAUNDERING RULE ON MUTUAL FUND DUE DILIGENCE

Last week the Treasury Department published a final rule that will require mutual funds with accounts for foreign financial institutions to implement due diligence programs and to make routine money laundering risk assessments of such foreign financial institutions.[1]

Mutual funds have been subject to an anti-money laundering program requirement since 2002. An anti-money laundering program must be designed to prevent a mutual fund from being used for money laundering or terrorist financing activities. While that may seem to involve the assessment of the money laundering risk presented by investors, the fact is that mutual funds have not been required to make money laundering risk assessments routinely in the past. Now Treasury's new KNOW YOUR CUSTOMER rule will pose a challenge for most mutual funds.[2]

When It Applies

The rule will apply to mutual fund accounts opened on or after April 4, 2006. Accounts existing on April 4 will become subject to the rule on October 2, 2006.

What Accounts Are Affected

There are two parts to this new rule (31 CFR 103.176 and 104.178). The first part is important for most mutual funds; the second part is not.

Correspondent Accounts. The first rule applies to each "correspondent account" established by a mutual fund. The term "correspondent account" is defined very broadly to include any account established in the United States for a foreign financial institution "to receive deposits from, or to make payments or other disbursements on behalf of, the foreign financial institution, or to handle other financial transactions related to such foreign financial institution."

An "account" with a mutual fund is any "contractual or other business relationship" with the fund for the provision of regular services "to effect transactions in securities issued by the mutual fund," including purchases and sales of such securities. The account must be with the mutual fund; a foreign financial institution that purchases mutual fund shares through an account with a broker-dealer does not thereby establish an account with the mutual fund. An account is for the provision of *regular* services; the rule does not apply to one-time or infrequent transactions.

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1 71 Fed. Reg. 496 (January 4, 2006).

2 The rule applies to "covered financial institutions," which include, besides mutual funds, depository institutions, broker-dealers, futures commission merchants and commodities introducing brokers. (Depository institutions and broker-dealers currently are subject to a rule prohibiting accounts for "foreign shell banks" and requiring some due diligence regarding foreign banks that open accounts.)

The upshot is that virtually any investor in a mutual fund holds a "correspondent account" with the fund. (Treasury notes that the definition is broad enough to include a custody account or escrow account, but mutual funds do not offer such accounts.) It will be useful for some fund families to remember that the rule applies only to accounts established in the United States.

Foreign Financial Institutions. Not all accounts are affected—only those opened for "foreign financial institutions." These include:

- foreign banks;
- foreign branches or offices of domestic banks, broker-dealers, futures commission merchants, commodities introducing brokers or mutual funds;
- firms located and organized abroad (not including their U.S. branches or offices) that are by U.S. standards broker-dealers, futures commission merchants, commodities introducing brokers or mutual funds;[3] and
- firms located and organized abroad (not including their U.S. branches or offices) that are engaged in the business of currency dealers or exchangers or money transmitters. "Engaged in the business" means engaged more than incidentally, so that (Treasury's example) hotels that exchange currency for guests are not necessarily engaged in the business of exchanging currency.

Private Banking Accounts. Although mutual funds are covered by the second rule, which applies to "private banking accounts," few mutual funds offer such accounts. A "private banking account," among other things, must *require* a minimum of funds or assets of at least $1 million.

Due Diligence Programs

Every mutual fund that maintains accounts in the United States for foreign financial institutions must establish a *due diligence program* as part of its anti-money laundering program. The program is to include due diligence (and ultimately enhanced due diligence) policies, procedures and controls designed to detect and prevent money laundering through such accounts. The policies, procedures and controls must be *risk-based* and *specific*.

A due diligence program has three parts.

1. Determining whether the foreign financial institution is a paragraph (b) foreign bank. A mutual fund must determine in each case whether the foreign financial institution opening or maintaining the account is a foreign bank subject to paragraph (b). This part of the due diligence program will be on hold for a while because Treasury did not adopt section 103.176(b)-(c) as part of the final rules; rather, it reproposed this part of the rule for comment.[4] Mutual funds'

[3] The rule refers to companies organized under foreign law that, if they were located in the United States, would be "covered financial institutions" under the rule; see note 2 above.

[4] As proposed, a foreign bank subject to paragraph (b) is a foreign bank (including the foreign branches and offices of a domestic bank but not the U.S. branches, agencies and offices of a foreign bank) operating under—

Footnote Continued

anti-money laundering programs should include procedures for this part of the due diligence program that can be implemented when Treasury adopts a final rule.

2. Assessing the money laundering risk presented by the account. A mutual fund must assess in each case the money laundering risk presented by the account, based on all relevant factors. Relevant factors include, but by no means are limited to—

- the nature of the foreign financial institution's business and markets and the extent to which such business and markets present increased money laundering risk;
- the nature, purpose and anticipated activity of the account; this factor requires a mutual fund to ascertain and record the investment goals and expected investment activity of its foreign financial institution investors, so that this information may be compared later with actual account activity;
- the nature and duration of the mutual fund's relationship with the foreign financial institution (and its affiliates);
- the anti-money laundering and supervisory regime of the country that issued the charter or license to the foreign financial institution and, to the extent public information is available, of the country in which any company that owns the foreign financial institution is organized;[5] and
- information known by or reasonably available to the mutual fund about the foreign financial institution's anti-money laundering record. (Available information includes information in industry guides and periodicals and information available from Treasury and other government sources, possibly including Federal Reserve determinations regarding comprehensive consolidated bank supervision made in the course of foreign bank applications.)

These factors are in addition to other factors that demand investigation in particular cases.

The due diligence program is to be *risk-based*. Treasury advises that the program should contemplate a range of due diligence measures, based on the risk assessment of the account. For example, Treasury believes that the scope and depth of a mutual fund's review of available information about a foreign financial institution's anti-money laundering record will depend on what the review uncovers initially.

- an *offshore banking license*, which is a banking license that prohibits the licensee from conducting banking activities with the citizens of, or in the currency of, the issuing country, or
- a banking license issued by a foreign country designated as non-cooperative by an international anti-money laundering organization such as the Financial Action Task Force, or
- a banking license issued by a foreign country designated by Treasury for special measures.

(At present only Burma (Myanmar), Nauru and Nigeria are listed as non-cooperative. Treasury has adopted final rules requiring certain special measures against Burma (Myanmar) and against Myanmar Mayflower Banks and Asia Wealth Bank. Other special measures have been proposed, but not adopted.)

[5] While not listed by the FATF as non-cooperative, several countries may present high money laundering risk, such as Indonesia, Lebanon, the Philippines, Zimbabwe, Russia, Guatemala or Venezuela, to name a few.

The program is to be *specific*. It should employ the listed risk factors "at a level of specificity and detail appropriate to that institution's foreign correspondent account operations and the types of accounts offered." Most mutual funds, of course, offer just one type of account, but the extent and nature of their business with foreign investors may vary widely; each mutual fund will need to consider how the listed factors and other factors can be relevant to its business.
Treasury clarifies in its release that a due diligence program requires only an assessment of the money laundering risk presented by the foreign financial institution holding the account, and not of the risk presented by its customers. It will be unnecessary to "look through" intermediaries (funds of funds, omnibus accounts, trust accounts and other investment vehicles) that open accounts with mutual funds.

3. Monitoring the account. The mutual fund must apply risk-based procedures and controls to monitor each account held by a foreign financial institution, in order to detect and report money laundering. This ongoing account monitoring must include periodic account reviews to determine whether account activity is consistent with the information initially obtained regarding the purpose and expected activity in the account.

Enhanced Due Diligence

Treasury's proposed rule on enhanced due diligence measures ultimately will be part of the due diligence rule; enhanced due diligence policies, procedures and controls will be part of a due diligence program and will apply to accounts for foreign banks that are subject to paragraph (b). As noted above, determining whether a foreign financial institution is a paragraph (b) foreign bank is the first step of a due diligence program, but implementation of this procedure will be deferred until Treasury adopts a final rule on enhanced due diligence.[6]

When Due Diligence Cannot Be Completed

The new rule requires that a mutual fund's due diligence program include procedures for circumstances in which the mutual fund is unable to perform appropriate due diligence with respect to an account for a foreign financial institution. This may occur, for example, if the foreign financial institution refuses to provide necessary information.[7] The procedures should specify when an account is not to be opened, an account is to be closed, or transaction or payment activity is to be suspended, and when a suspicious activity report is to be filed.

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6 71 Fed. Reg. 516 (January 4, 2006). The proposed rule will require enhanced scrutiny of any account for a paragraph (b) foreign bank. It will require a determination whether the foreign bank in turn maintains correspondent accounts for other foreign banks (such as omnibus accounts in which they can invest in a mutual fund through the foreign bank) and, if it does, an assessment of the money laundering risks associated with such correspondent accounts for other foreign banks. Finally, it will require identification of each owner of the foreign bank and of his ownership interest if the foreign bank is not publicly traded.

7 Necessary information should include required customer identification and verification information, as well as information about the foreign financial institution's business and markets and the purpose of and expected activity in the account.

An Important Procedure Overlooked By Treasury

Mutual funds will have to come to grips with the problem of identifying "foreign financial institutions" in constructing their due diligence programs, something Treasury does not discuss in its release. They will need routine account opening procedures for determining when a foreign investor is a foreign financial institution. This will not always be obvious.

Presumably, a company is engaged in the businesses of its subsidiaries. A company that owns a money transmission business is engaged in that business, even though it may seem to be an ordinary commercial enterprise and not a financial institution. Similarly, a travel agency or tour operator might own a currency exchanger, but not otherwise give any hint of being in a financial business. A mutual fund will need to obtain information from every foreign investor about its businesses and subsidiaries in order to ascertain whether it is a foreign financial institution.[8]

In Conclusion

Mutual funds have enjoyed a deferment since 2002 of the requirement of section 312 of the PATRIOT Act of due diligence related to accounts in the United States for foreign persons. Now Treasury's new rule imposes that requirement, but limits the scope of the due diligence to accounts for foreign financial institutions. The due diligence programs mandated by this rule must be risk-based and specific and they will involve regular money laundering risk assessments. This will be a new field of anti-money laundering endeavor for most mutual funds.

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8 Definitions of "currency dealer or exchanger" and "money transmitter" are at 31 CFR 103.11(uu)(1) and (5).