# TREASURY DEPARTMENT ISSUES GUIDANCE TO ASSIST MUTUAL FUND COMPLIANCE WITH SUSPICIOUS ACTIVITY REPORT FILINGS BEGINNING ON OCTOBER 31, 2006

Mutual funds need to address a significant new anti-money laundering requirement at the end of this month. Suspicious activity reporting is a new development that, along with several others, extends anti-money laundering requirements to mutual funds. In May of this year, the Treasury Department issued a final rule to extend suspicious activity reporting to mutual funds. The requirements of the rule apply to transactions, or patterns of transactions, occurring after October 31, 2006.

On October 4, 2006, the Treasury Department's Financial Crimes Enforcement Network ("FinCEN") issued guidance in the form of frequently asked questions to assist mutual funds in complying with the new requirements. FinCEN consulted with the Securities and Exchange Commission ("SEC") staff prior to issuing the guidance. The guidance emphasizes that meeting the Suspicious Activity Report ("SAR") filing requirements does not guarantee that a mutual fund will meet all of its obligations under the Bank Secrecy Act.

Under the final rule, mutual funds are required to report to FinCEN any transaction conducted or attempted by, at, or through a mutual fund that, alone or in the aggregate, involves at least $5,000 in funds or other assets, if the mutual fund knows, suspects, or has reason to suspect that the transaction:

- involves funds derived from illegal activity or is intended or conducted to hide or disguise funds or assets derived from illegal activity;
- is designed, whether through structuring or other means, to evade the requirements of the Bank Secrecy Act (including applicable provisions of the USA Patriot Act);
- has no business (including investment) or other apparent lawful purpose or is not the sort of transaction in which the particular customer would be expected to engage, and is a transaction for which the mutual fund knows of no reasonable explanation after examining the available facts, including the background and possible purpose of such transaction; or
- involves the use of the mutual fund to facilitate criminal activity (which includes transactions in which legally derived funds are used for criminal activity).

FinCEN expects that a mutual 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, consistent with the mutual fund's required anti-money laundering procedures. FinCEN notes that the obligation to report a transaction as suspicious applies regardless of whether the transaction involves currency, and that many noncurrency transactions (e.g., fund transfers) can be indicative of suspicious or illicit activity. Additionally, mutual funds are encouraged to report voluntarily suspicious transactions that do not meet the mandatory SAR levels, even if the transactions are below the $5,000 threshold. Both mandatory and voluntary reporting is protected from civil liability. SARs must be filed on a specific form called SAR-SF (FinCEN Form 101), which is used for suspicious activity reports filed by the securities and futures industries. The form permits one mutual fund to file on behalf of all mutual funds involved in a particular transaction or series of transactions, if all mutual funds are identified in the SAR narrative. Additionally, a mutual fund is permitted to file a joint SAR with a broker-dealer, or other financial institution required to file a SAR, when the entities are jointly involved in the same suspicious transaction or series of suspicious transactions.

A mutual fund must file within 30 days after the initial detection of a suspicious transaction. If the mutual fund is unable to identify a suspect when the activity is first detected, it may delay filing for an additional 30 days but it may not delay filing for more than 60 days after the date of the initial detection. In cases that require immediate attention, a mutual fund must notify appropriate law enforcement officials by telephone in addition to making the timely SAR filing. The mutual fund is also encouraged to contact FinCEN and the SEC. The Treasury Department has delegated to the SEC its authority to examine mutual funds for compliance with the requirement to report suspicious transactions and for compliance with the Bank Secrecy Act and its implementing regulations.

Mutual funds must consider all of the facts and circumstances relating to a customer and the transaction involved prior to filing a SAR. However, FinCEN has identified certain types of situations that may raise "red flags" and indicate a need to file a SAR, including the following:

- The activities vary substantially from the customer's normal practices.
- A customer refuses to provide information necessary for the mutual fund to verify the customer's identity, make reports, or keep records required by the Bank Secrecy Act.
- A customer provides information that the mutual fund determines to be false.
- Funds are transmitted or received without normal identifying information, or in a manner that may indicate an attempt to disguise or hide the country of origin or destination, or the identity of the person sending or receiving the funds, or the identity of the beneficiary receiving the funds.
- A customer seeks to change or cancel a transaction after being informed of information verification or recordkeeping requirements.
- The mutual fund is used repeatedly as a temporary resting place for funds from multiple sources without a clear business (including investment) purpose.

This last item identified as a potential "red flag" may prove to be difficult for mutual funds to utilize as a tool to identify suspicious activity, especially if the investor suitability review has been done by a bank or a broker dealer and relied upon by the mutual fund.

A mutual fund is permitted to contract with an affiliated or unaffiliated service provider to perform the reporting obligation under the suspicious activity reporting rule as the fund's agent. The mutual fund remains responsible for assuring compliance with the suspicious activity requirements and must monitor performance by the service provider. However, another case where it may prove to be difficult for mutual funds to comply with the SAR filing requirements involves the expectation that a mutual fund will file suspicious activity reports for transactions in fund shares by a broker-dealer or other financial institution (collectively, "intermediaries") on behalf of its customers through the Fund/SERV system operated by the National Securities Clearing Corporation ("NSCC"). The FinCEN Q&A guidance acknowledges that the intermediaries would be the customers of the mutual fund, and that the fund may have limited information about the customers of the intermediary but the mutual fund is still obligated to file a SAR if the mutual fund knows, suspects, or has reason to suspect that a transaction involving a customer of the intermediaries is suspicious. By contrast, under the Customer Identification Program ("CIP") requirements applicable to mutual funds, a mutual fund does not need to perform a CIP review of NSCC Fund/SERV system accounts, except at the intermediaries' level.

Mutual funds, along with their directors, officers, employees, and agents are prohibited from disclosing that the mutual fund filed a SAR or from providing any information that would disclose that a report has been prepared or filed, except in instances of joint filing and for communications with service providers. A mutual fund may not disclose the existence of a SAR to the subject of the report. Upon receipt of a subpoena requesting disclosure of a SAR, a mutual fund must decline to produce the SAR or to provide any information that would disclose that a SAR was prepared or filed. The mutual fund also must notify FinCEN of any such subpoena request.

Importantly, FinCEN has determined that a U.S. mutual fund may share a SAR with the investment adviser (and with each other entity in the chain of control in the parent company) that controls the fund, whether domestic or foreign. FinCEN acknowledges the need for investment advisers to implement enterprise-wide risk management and compliance functions over all the mutual funds they manage. However, subadvisers are not viewed as typically controlling a fund, as such, they are not within the scope of this guidance and therefore cannot receive a SAR from a mutual fund even if as an investment adviser they perform limited functions in managing a mutual fund's securities portfolio. Moreover, mutual funds, as part of their anti-money laundering programs, must have written confidentiality agreements or arrangements specifying that the investment adviser must protect the confidentiality of SARs through appropriate internal controls. There are additional considerations involved in connection with such agreements if the SAR is to be shared with a non-U.S. investment adviser.

Mutual funds must make records available upon request to FinCEN, the SEC and appropriate law enforcement and regulatory authorities. Mutual funds must keep copies of SAR filings and all original supporting documentation for five years.

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If you have any questions regarding this memorandum, please contact Timothy R. McTaggart (202-303-1121, tmctaggart@willkie.com), Benjamin J. Haskin (202-303-1124, bhaskin@willkie.com) or the attorney with whom you regularly work.

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October 28, 2006