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Comment Letter on Correspondent Account Rules Proposed Under Patriot Act, February 2002

February 11, 2002

Office of the Assistant General Counsel (Enforcement)
Attention: Official Comment Record
Room 2000
Department of the Treasury
1500 Pennsylvania Ave., N.W.
Washington, DC 20220

RE: Notice of Proposed Rulemaking in Foreign Bank Correspondent Accounts, 66 Fed. Reg. 67460 (December 28, 2001)

Dear Sir or Madam:

The Investment Company Institute[1] appreciates the opportunity to comment on the Department of the Treasury's Notice of Proposed Rulemaking on Counter Money Laundering Requirements—Correspondent Accounts for Foreign Shell Banks and Recordkeeping and Termination of Correspondent Accounts for Foreign Banks. The Institute strongly supports the important anti-money laundering policies underlying the rule and recognizes the need to impose obligations on covered financial institutions to further these objectives.

The proposed rule would prohibit a "covered financial institution"—which term includes US banks and broker-dealers registered with the SEC under the Securities Exchange Act of 1934 ("broker-dealers"), but not investment companies or their agents—from establishing, maintaining, administering, or managing a correspondent account in the United States for, or on behalf of, a foreign shell bank. The proposal also would require a covered financial institution to take reasonable steps to ensure that a correspondent account for a foreign bank is not being used indirectly to provide banking services to a foreign shell bank. In addition, under the proposed rule, a covered financial institution must maintain records identifying the owners of foreign correspondent banks and the name and address of a person in the United States who is authorized to accept service of process for the foreign bank.

As the foregoing makes clear, investment companies and their transfer agents are not covered specifically either by the proposed rule or by the provisions of the USA PATRIOT Act ("Patriot Act") that the rule seeks to implement. The Institute seeks clarification that the proposed rule does not apply to investment company transfer agents that are U.S. banks or broker-dealers with respect to their investment company transfer agency activities.[2] If, however, Treasury disagrees with our interpretation of the law and rule, we encourage Treasury to modify the rule in a number of respects to avoid material adverse effects on the activities of investment companies and their affiliates.

Our specific comments follow.

Treasury Should Clarify That Investment Company Transfer Agents That Are Banks Or Broker-Dealers Are Not Subject to the Proposed Rule.

As an initial matter, we seek clarification that the proposal would not apply to investment company transfer agents that are U.S. banks or broker-dealers with respect to their investment company activities. If the rule, as drafted, would apply to bank and broker-dealer transfer agents, we urge Treasury to exempt transfer agents from its coverage.[3]

By way of background, investment companies typically have no employees of their own; instead, they contract with affiliated and unaffiliated entities to provide services to the funds, including managing fund assets, safekeeping fund assets, and rendering shareholder accounting services. Transfer agents provide administrative services to investment companies by maintaining records of

shareholder accounts on behalf of the investment companies. Investment company shareholder accounts can include accounts opened in the name of foreign banks.

Although investment companies and transfer agents are not included in the list of covered financial institutions under section 313(a) of the Patriot Act or the proposed rule, banks and broker-dealers are covered. Because some transfer agents are banks or broker-dealers, investment company shareholder accounts administered by bank or broker-dealer transfer agents could be seen as falling within the scope of the proposed rule.

The Institute believes that the administration of investment company accounts by transfer agents that are U.S. banks or broker-dealers should not be covered by the proposed rule. These transfer agents are acting exclusively as agents for investment companies, entities that are not "covered financial institutions" under the Patriot Act or the proposed rule. If the rule were read to include investment company transfer agents, Treasury would, in effect, be extending the ambit of section 313(a) of the Patriot Act to cover institutions that Congress did not choose to include.

It is important to emphasize that a determination by Treasury that Congress did not intend investment company transfer agents that are banks or broker-dealers to be subject to the foreign correspondent bank rule with respect to their investment company activities does not mean that investment companies would not be subject to anti-money laundering requirements with respect to their foreign shareholders. Investment companies are included within the definition of a "financial institution" in the Bank Secrecy Act. As a result, investment companies will be required to implement anti-money laundering programs under section 352 of the Patriot Act and we anticipate that they will be subject to rules requiring customer identification and verification as well as suspicious activity reporting.

Finally, under section 356(c) of the Patriot Act, Treasury, jointly with the SEC and the Federal Reserve, is required to submit a report to Congress regarding the application of the Bank Secrecy Act to investment companies. We believe that extension of the foreign correspondent bank regime to investment companies is not necessary but, if Treasury believes otherwise, this could be addressed in the context of the report to be made to Congress.

Should Treasury disagree with our analysis and extend the rule to the activities of banks and broker-dealers acting as transfer agents for investment companies, we believe that it is important that the rule be narrowed in certain respects, and made more workable, as described below.

A. The Scope of the Rule Should be Narrowed.

1. The Proposal Should Not Impose Duplicative Responsibilities on Covered Financial Institutions for the Same Account.

The proposal, as currently drafted, potentially could require more than one covered financial institution to satisfy the requirements of the proposed rule for the same account in situations where more than one institution is involved with an account. Because we do not believe duplication of the same obligations for the same account would further anti-money laundering policies, we request that Treasury clarify that, in those situations, only the covered financial institution with the direct relationship with the foreign bank should be responsible for satisfying the requirements of the proposed rule. The covered financial institution closest to the customer would be best situated to make a determination regarding its customer's status as a foreign bank and to obtain information from the foreign bank as required by the rule.

For example, in the case of investment company shares sold through a retail broker-dealer, the broker-dealer would have a brokerage account for its customer and the transfer agent for the investment company also may have an account in the name of the same customer as a shareholder of the investment company. Even if the transfer agent is a broker-dealer or a U.S. bank, it seems unnecessary to require both the retail broker-dealer and the transfer agent to satisfy the obligations of the rule for the same account or for a foreign bank customer to have to complete two certifications for the same account. This duplication would serve no purpose. Because the retail broker-dealer would be the entity that would have direct contact with the customer, it would be in the best position to obtain information regarding its client's status as a foreign bank or foreign shell bank and to request information about a foreign bank's owners and agent for service of process. Consequently, we believe that only the retail broker-dealer should, in these situations, be subject to the requirements of the proposed rule.

2. Closed-End Investment Company Accounts Administered by Transfer Agents Should Be Excluded from the Proposed Rule.

Closed-end funds are investment companies whose shares are listed on a stock exchange or traded in the over-the-counter market. Similar to any other public issuer, closed-end funds may have foreign banks among their shareholders and thus, transfer agents of closed-end funds may have accounts in the name of foreign banks. We believe that closed-end funds should be treated as other public issuers and their shareholder accounts administered by transfer agents should be excluded from the rule. It should be noted that, because the vast majority of closed-end fund shares are sold through retail broker-dealers that also would have a brokerage

account for any foreign bank, safeguards to prevent transactions with foreign shell banks will apply at the broker-dealer level.

3. Certain Accounts with Minimal Contacts or Connections with the United States Should Not Be Subject to the Proposed Rule.

It is common for affiliates of US investment advisers to establish foreign mutual funds for sale to non-U.S. persons outside the United States. These funds may engage a U.S. entity to provide them with certain administrative services, including overseeing the performance of other companies that provide services to the fund, ensuring that the fund's operations comply with applicable legal and contractual requirements, and servicing shareholder accounts. In conjunction with these duties, these administrators may maintain accounts in the name of foreign banks that purchase fund shares for themselves or for their clients.

It is unclear whether the proposed rule would apply to U.S. banks or broker-dealers that provide such services to a foreign mutual fund, and thus, in effect, cover accounts of non-U.S. mutual funds that are sold to non-U.S. persons outside the United States. We do not believe that the Patriot Act was intended to cover these types of accounts. These non-U.S. accounts have only tenuous connections to the United States: they are essentially overseas accounts for which certain back office operations are being performed by a U.S. entity. In addition, because the administration of these funds by a U.S. entity is not necessary for non-U.S. mutual funds to operate or to be sold abroad, imposing the requirements of the proposed rule on these accounts may simply encourage these activities to be performed outside the United States by a non-U.S. entity, which would place U.S. entities at a competitive disadvantage.

B. Compliance with the Requirements of the Proposed Rule Should be Made More Workable for Investment Company Transfer Agents that are Banks or Broker-Dealers.

The Institute recognizes the importance of combating money laundering and that the requirements under the proposed rule are intended to further those policy objectives. The Institute supports these important objectives. If the rule is to apply to investment company transfer agents that are banks or broker-dealers, however, the Institute makes the following recommendations with respect to compliance obligations to alleviate undue burdens on covered financial institutions.

1. The Proposed Rules Should Distinguish between Existing and New Investment Company Accounts for Compliance Purposes.

The requirements of the proposed rule assume that covered financial institutions have some way of knowing that an accountholder is a foreign bank. However, unlike banks, which are subject to "know-your-customer" obligations, and broker-dealers, which are subject to certain suitability obligations with respect to securities recommendations, investment companies and their agents have not had a reason to distinguish among types of shareholders or retain records indicating the status of a shareholder as a foreign bank. As a result, it would be extremely difficult for bank or broker-dealer transfer agents to determine which existing investment company shareholders should receive a certification form. We, therefore, recommend a bifurcated approach to new and existing investment company shareholder accounts.

With respect to accounts for new clients, investment company transfer agents that are banks or broker-dealers could seek to determine whether a client is a foreign bank. This could occur during the account opening process: transfer agents could request certifications when opening the account from any shareholder identified as a foreign bank. New account forms for mutual fund accounts could be modified so that shareholders could indicate whether they are foreign banks, as defined under the rule. As discussed more fully below, we request confirmation that covered financial institutions be permitted to rely on certifications received from a foreign bank and need not verify the form for accuracy absent circumstances that would raise questions regarding the veracity of the responses.

It would, however, be extremely difficult and costly for transfer agents to have to obtain from their existing foreign clients sufficient information to determine whether the foreign client is a foreign bank. For this reason, we suggest that for existing accounts of foreign shareholders, bank or broker-dealer transfer agents only be required to take reasonable and practical steps to determine whether the client could be a foreign bank. Such steps could consist of reviewing the information in the transfer agent's possession and seeking information from the client where the information indicated that the client was, or could be, a foreign bank. For accounts for which information in the transfer agent's possession does not indicate they could be a foreign bank, bank and broker-dealer transfer agents for investment companies also could attempt to obtain more information about a foreign shareholder's status as a possible foreign bank at the same time that they obtain updated Forms W-8 for certain of their non-resident accounts under existing solicitation procedures.[4] This approach to existing accounts would avoid unnecessary administrative burdens on funds and their agents while assuring that funds obtain additional information about existing foreign shareholder accounts not thought to be banks in coordination with their existing procedures.

2. Periodic Reviews Should Be Required Every Three Years.

We request that the requirement in the proposal to review periodically the foreign bank's status be revised to require recertification every three years, rather than every two years, to coincide with the process for updating W-8 forms for certain non-resident aliens. This would make compliance with the rule significantly less burdensome and costly for investment company agents while still assuring that recertification occurs on a regular basis.

3. The Proposed Rule Should Clarify Whether the Certification Forms Must Be Checked by the Covered Financial Institution for Completeness or Accuracy.

It is unclear from the proposal whether the safe harbor would be available automatically to a covered financial institution that has received a completed certification form from a foreign bank or whether the covered financial institution must ensure that the information submitted on the form is accurate and provides complete ownership information. We request that the proposed rule clarify that a covered financial institution would not be required to verify the accuracy or completeness of the information on the certification form unless the covered financial institution has a reason to know or suspect that the information is inaccurate or incomplete. The certification forms should likewise be revised to reflect this clarification by eliminating "accepted" before the required signature of the covered financial institution.

4. The Proposed Rule Should Eliminate the Requirement to Terminate Accounts of Foreign Banks That Do Not Provide a Certification.

For several reasons, we suggest that Treasury eliminate the obligation in the proposal for covered financial institutions to terminate accounts of foreign banks that do not provide the required information or the certification. First, termination of a mutual fund shareholder account is more complex than closing a cash deposit account and may expose mutual funds to potential liability. Termination of a mutual fund account would involve redeeming the shares of the mutual funds. Because the redemption proceeds will depend on the market value of the portfolio securities on the day of the account termination, a shareholder whose shares were redeemed on a day of a market downturn could attempt to hold the fund liable for losses or potential losses.

Although the proposed rule would provide a limitation on liability for covered financial institutions that terminate accounts for which a certification has not been received, it is unclear whether Treasury has the authority to provide such a safe harbor under the Patriot Act. The Act specifically provides a limitation of liability for covered financial institutions that terminate an account after receipt of a written notice from the Secretary or the Attorney General, but it does not provide a similar liability limitation where a covered financial institution terminates an account for a bank's failure to provide a certification. We question whether this provision of the Act provides an adequate basis for Treasury to extend the liability limitation to terminations of accounts for which foreign banks do not provide certifications. Without an adequate limitation of liability, termination could potentially expose mutual funds to significant liability.

Second, the operation of the requirement to terminate accounts may facilitate fraud on mutual funds or money laundering. Frequently, funds drawn on foreign checks to purchase mutual fund shares can take a long period of time (e.g., 60 days or more) to clear. A covered financial institution that is required to terminate a mutual fund shareholder account for lack of a certification could be forced to send the redemption proceeds before the foreign bank's funds have been received by the mutual fund. This would allow a foreign bank to perpetrate fraud against the mutual fund by permitting the foreign bank to receive redemption proceeds before the foreign bank's check has cleared. Moreover, the obligation to terminate could facilitate money laundering by providing the foreign bank with a check drawn from the fund's account in exchange for its own check.

We suggest that instead of terminating accounts for which covered financial institutions have not received certifications, the rule permit covered financial institutions to retain records of foreign banks that have not provided certifications and/or to provide the Secretary or the Attorney General with a list of such foreign banks. These accounts would be frozen until a certification is received from the foreign bank. This approach would be consistent with the treatment of customers who fail to provide taxpayer identification numbers ("TINs") for bank and securities accounts. Under Bank Secrecy Act regulations, if a customer fails to provide a TIN, the bank or broker-dealer can keep the account open, but it must maintain a list of those persons for whom it has not been able to obtain a TIN.[5]

Should Treasury determine to retain the termination requirement, we wish to point out that termination creates additional issues for certain special types of investment companies that should be addressed. Interval funds are investment companies that redeem shares at set intervals, such as monthly or quarterly. These funds are redeemable only periodically to enable the investment companies to invest in less liquid securities. Termination of an interval fund account requiring redemption of certain shares could materially disadvantage the other shareholders of the fund. For these types of funds, we request that covered financial institutions be permitted to terminate accounts at the predetermined intervals even for those accounts for which a written notice has been received from the Secretary or the Attorney General. In addition, if the final rule does not exclude closed-end funds as we recommended above, it should exempt them from the termination requirement. Because closed-end fund shares are not redeemed by the issuer as in the case of mutual fund shares, transfer agents for closed-end funds could not terminate unilaterally a shareholder account. Unilateral termination also would be impossible if the fund has issued physical certificates to the shareholder because the

shareholder would have to surrender its certificates for the fund to close the account.

In the case of interval funds, closed-end funds, or when physical shares have been issued, the account could be frozen until the redemption can be effected. This approach would be in keeping with Treasury's recognition in the preamble to the proposed rule that for open securities or futures positions, a covered financial institution may exercise its commercially reasonable discretion in liquidating the position so long as it takes reasonable steps to ensure that the account is not permitted to establish new positions.

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The Institute appreciates the opportunity to comment on the proposed rule. We would be pleased to answer any questions or discuss any of these issues further. You may contact me at (202) 326-5815 or at tyle@ici.org or Mary S. Podesta, Senior Counsel, at (202) 326-5826 or at podesta@ici.org.

Very truly yours,

Craig S. Tyle
General Counsel

cc: Gary W. Sutton
Office of the Assistant General Counsel (Banking & Finance)
Department of the Treasury

William Langford
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ENDNOTES

[1] The Institute is the national association of the US investment company industry. Our membership includes 9,040 open-end investment companies ("mutual funds"), 484 closed-end investment companies, and six sponsors of unit investment trusts. Our mutual fund members have assets in excess of $6.9 trillion, accounting for approximately 95% of total US industry assets, and over 88.6 million individual shareholders.

[2] Alternatively, Treasury should modify the rule to exempt bank and broker-dealer transfer agents from its coverage.

[3] This approach would be consistent with the exemption provided to bank credit card systems from the definition of financial institution under Bank Secrecy Act regulations. 31 CFR §103.11 (n) (1).

[4] To ensure collection of the appropriate amount of US withholding and backup withholding tax, US tax rules generally require paying agents to obtain information from all individuals, including persons that are neither citizens nor residents of the United States (non-resident aliens). In general, a paying agent is required to obtain an updated Form W-8 from a non-resident alien by the last day of the third calendar year following the year in which the Form W-8 is signed (i.e.,a Form W-8 signed on September 30, 2001 would remain valid until December 31, 2004). See Treas. Reg. § 1.1441-1(e)(4)(ii).

[5] 31 CFR § 103.34 (a) (1) and 103.35 (a) (1).

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