



DEPARTMENT OF THE TREASURY
FINANCIAL CRIMES ENFORCEMENT NETWORK

MAR - 2 2006

Robert C. Grohowski
Senior Counsel, International Affairs
Investment Company Institute
1401 H Street, N.W.
Washington, DC 20005-2148

Re: *Application of the Rule regarding Special Due Diligence
Programs for Certain Foreign Accounts to Fund/SERV Accounts*

Dear Mr. Grohowski:

I am responding to your letter of February 3, 2006, seeking guidance on the due diligence obligations of mutual funds under the new regulations implementing section 312 of the USA PATRIOT Act ("section 312").¹ Specifically, you have requested that we determine for whom a mutual fund establishes, maintains, administers, or manages an account when its shares are purchased or redeemed by a U.S. financial institution through the Fund/SERV system of the National Securities Clearing Corporation ("NSCC") on behalf of a foreign financial institution.

As you indicated in your letter, NSCC's Fund/SERV system streamlines the clearance and settlement of mutual fund transactions by enabling NSCC members to transact business with hundreds of mutual fund families and thousands of mutual funds through a single, standardized process. Transactions in mutual fund securities cleared and settled through Fund/SERV are recorded by a mutual fund's transfer agent on the NSCC member's account, although the member in certain circumstances also may rely upon the fund's transfer agent to perform discrete recordkeeping tasks pursuant to a networking agreement. You stated that in order for a foreign financial institution to effect mutual fund purchases and redemptions through Fund/SERV it must either establish an account with an NSCC member, or become directly a member of the NSCC.²

Provided that the NSCC member is a U.S. financial institution subject to the provisions of section 312, we believe that the mutual fund in question is establishing, maintaining, administering, or managing an account for the NSCC member, rather than

¹ *Anti-Money Laundering Programs; Special Due Diligence Programs for Certain Foreign Accounts; Final Rule and Proposed Rule*, 71 Fed. Reg. 496 (January 4, 2006).

² NSCC membership is limited to financial institutions domiciled or regulated in the United States and other firms approved by the NSCC Board of Directors. Currently no foreign financial institution is an NSCC member firm.

for the NSCC member's customer.³ Consequently, in such circumstances, we do not believe that the mutual fund establishes, maintains, administers, or manages a correspondent account for a foreign financial institution. However, in the event that a foreign financial institution becomes an NSCC member, the mutual fund *would* be required to treat that foreign financial institution as a correspondent account subject to the appropriate level of due diligence and monitoring.

In arriving at the conclusions in this letter, we have relied upon the accuracy and completeness of the representations made in the letter and attachments you submitted to us on February 3, 2006. Nothing precludes us from reaching a different conclusion or taking further action should circumstances change or any of that information prove inaccurate or incomplete.

If you have any questions about this letter, please contact William Middlebrooks or Beverly Loew in our Office of Regulatory Policy at (202) 354-6400.

Sincerely,



William D. Langford, Jr.
Associate Director
Regulatory Policy and Programs Division

cc: Hunter Jones, Assistant Director
Office of Regulatory Policy
U.S. Securities and Exchange Commission

³ This determination is limited to the mutual fund's obligations under section 312, and should not be interpreted as a limitation upon the mutual fund's obligations under other Bank Secrecy Act regulations.



ROBERT C. GROHOWSKI
SENIOR COUNSEL – INTERNATIONAL AFFAIRS

February 3, 2006

Via e-mail

William Langford
Associate Director
Regulatory Policy and Programs Division
Financial Crimes Enforcement Network
U.S. Department of the Treasury
Washington, D.C.

Dear Mr. Langford:

The Investment Company Institute¹ is writing to request your concurrence in our interpretation of the correspondent account provisions in the new rules under Section 312 of the USA PATRIOT Act (the “Correspondent Account Rule”).² We respectfully request that Treasury concur with our view that Fund/SERV accounts (defined below) are “established, maintained, administered, or managed,” as those terms are used in the Correspondent Account Rule, by the mutual fund for the NSCC member firm and not for the firm’s customers.³ We believe that this interpretation is clearly supported by the rule text and fully consistent with both the policies underlying the USA PATRIOT Act and the Treasury staff’s earlier interpretation of the mutual fund customer identification program rule (the “CIP Rule”) in the Fund/SERV context.

Given the Correspondent Account Rule’s April 4th implementation deadline for new accounts and the fundamental importance of Fund/SERV to the processing of purchases, redemptions, and exchanges of mutual fund shares, we strongly urge Treasury to respond as quickly as possible.

The Application of the Correspondent Account Rule to Fund/SERV Accounts

The Correspondent Account Rule requires every mutual fund to establish a due diligence program reasonably designed to enable it to detect and report money laundering activity involving any correspondent account established, maintained, administered, or

¹ The Investment Company Institute is the national association of the U.S. investment company industry. More information about the Institute is available in Attachment A.

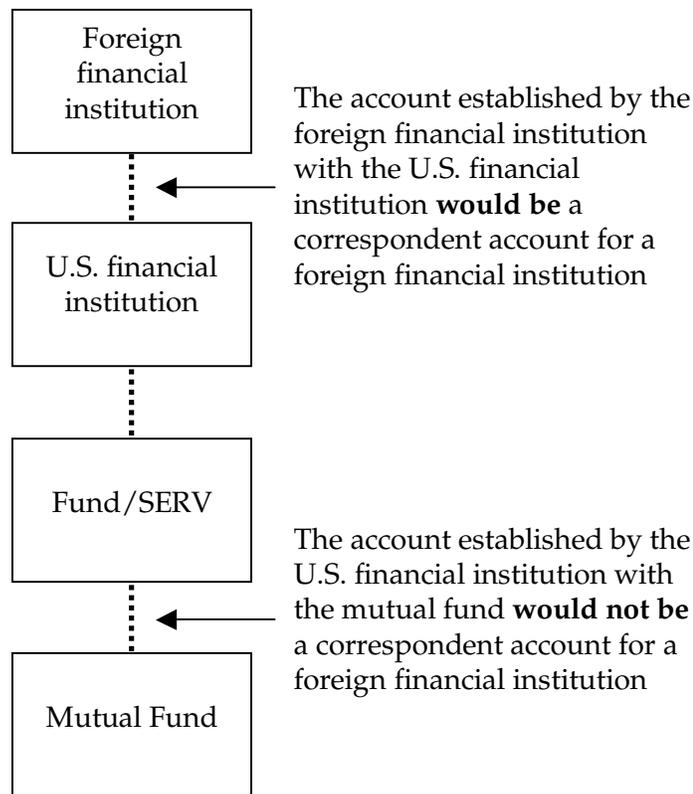
² 31 C.F.R. § 103.176. *See also* 71 Fed. Reg. 496 (January 4, 2006) (adopting the Correspondent Account Rule and 31 C.F.R. § 103.178 relating to due diligence programs for private banking accounts). In this letter, we are addressing only the Correspondent Account Rule. We are not addressing the private banking rule in 31 C.F.R. § 103.178.

³ For simplicity, we are using the terms “firm” to refer to the NSCC member firm, typically a broker-dealer, transacting via Fund/SERV on behalf of its customers and “fund” to refer to each mutual fund in which the firm invests on behalf of its customers.

managed by the mutual fund for a foreign financial institution.⁴

We are writing with respect to accounts opened by U.S. financial institutions with mutual funds for the purpose of effecting transactions of fund shares that are cleared and settled through the National Securities Clearing Corporation's Fund/SERV system ("Fund/SERV accounts"). We believe that the Correspondent Account Rule does not apply to a Fund/SERV account established, maintained, administered, or managed for an NSCC member firm that is a U.S. financial institution, even if the firm's customer is a foreign financial institution.⁵ In that case, the Correspondent Account Rule would apply to the account held by the NSCC member firm for the foreign financial institution. *See Figure 1.*

Figure 1



A. Background on Fund/SERV

For purposes of our analysis, we briefly describe below several characteristics that apply to all mutual fund accounts established through Fund/SERV:

⁴ 31 C.F.R. § 103.176(a).

⁵ The term "foreign financial institution" is defined in 31 C.F.R. § 103.175(h).

- Access to the Fund/SERV system is restricted to NSCC member firms. NSCC membership is limited to financial institutions domiciled or regulated in the U.S. and other firms approved by the NSCC Board of Directors.⁶ Foreign financial institutions are eligible for membership in NSCC only if they fit within one of the NSCC membership categories. We understand that no foreign financial institution currently is an NSCC member firm.⁷
- Mutual funds are *not* required to verify the identity of customers of an NSCC member firm that invest in mutual funds through the firm via Fund/SERV. In August 2003, the staff of Treasury and the SEC issued a joint FAQ that addresses the application of the CIP Rule to Fund/SERV accounts. In answer to the question of whether, in that context, the firm's customers also are customers of the mutual fund, the staff responded:
 - A: No. . . . [I]f an intermediary opens an account with a mutual fund through the NSCC Fund/SERV system, the intermediary would be the person that opens the new account, and the intermediary's customers would not be customers of the mutual fund.⁸
- The clearance and settlement process through Fund/SERV is completely separate and distinct from the investor's funding of his or her transactions.⁹ As a result, the fund has no knowledge of the source of the investor's funds.
- The investor's relationship with the NSCC member firm is such that the investor will be subject to the NSCC member firm's AML policies and procedures, including any policies and procedures with respect to correspondent accounts for foreign financial institutions. Accordingly, the NSCC member firm will have a legal duty to determine whether the investor is a foreign financial institution (as defined in the Correspondent Account Rule) and subject the investor's account to the appropriate level of due diligence required by the Correspondent Account Rule.

Additional background information on Fund/SERV is contained in Attachment B.

⁶ See NSCC Rule 2-1.

⁷ If a foreign financial institution is or becomes an NSCC member firm, the Correspondent Account Rule will require mutual funds to treat any Fund/SERV accounts relating to that firm as correspondent accounts subject to the appropriate level of due diligence and monitoring.

⁸ See Guidance from the Staffs of the Department of the Treasury and the U.S. Securities and Exchange Commission, *Questions and Answers Regarding the Mutual Fund Customer Identification Program Rule (31 CFR 103.131)*, available at <http://www.sec.gov/divisions/investment/guidance/qamutualfund.htm>.

⁹ Fund/SERV streamlines the settlement process between firms and funds by calculating a net settlement figure for each participant every day, which is settled with a single wire transfer. For example, a broker-dealer may have thousands of customers who buy and sell shares of various mutual funds each day. Fund/SERV will calculate a single net amount that the broker-dealer must either wire (if its customers are net purchasers) or that NSCC will wire to the broker-dealer (if its customers are net sellers). This process is completely separate from the customer's funding of the individual transactions, which is entirely a function of the customer's relationship with the firm.

B. Policy Reasons for an Approach for Fund/SERV Accounts Under the Correspondent Account Rule Similar to the CIP Rule

As noted above, Treasury and SEC staff analyzed the application of the CIP Rule to NSCC member firms' customers in the Fund/SERV context in 2003, concluding that mutual funds are not required to verify the identity of NSCC member firms' customers. The same policy rationales underlying the staff interpretation on the CIP Rule apply with respect to the treatment of Fund/SERV accounts under the Correspondent Account Rule.

In our letter to the staff on the CIP Rule, we pointed out that investors in the Fund/SERV context clearly are customers of the NSCC member firm, as they must open an account with that firm in order to purchase fund shares. To the extent that the firm is a broker-dealer or other financial institution subject to CIP obligations, it verifies each investor's identity in accordance with its CIP. Thus, investors do not have access to mutual funds through Fund/SERV without undergoing verification of identity.

Similarly, foreign financial institutions only could access mutual funds through Fund/SERV by conducting transactions through a U.S. financial institution, subject to that institution's AML procedures, or by conducting transactions directly with the mutual fund, subject to the fund's AML procedures. Our interpretation thus does not create any gaps in the scope or strength of the Correspondent Account Rule's protections.

In our earlier letter, we also pointed out the needless duplication of effort and expense that would result from an interpretation of the CIP Rule that required funds to verify the identity of firms' customers. As recognized in the staff FAQ, "only limited information (if any information at all) about individual customers is provided to the mutual fund" in the Fund/SERV account context. Mutual funds have no way to "know" a firm's customers given the existing Fund/SERV account opening processes. As a result, an interpretation that funds have to identify and verify NSCC member firm's customers would have resulted in dramatic and expensive changes to the entire system of processing orders through Fund/SERV.

An interpretation that the Correspondent Account Rule applies to mutual fund accounts in the Fund/SERV context will effectively reverse the staff's position on the CIP Rule, in essence requiring mutual funds to treat certain persons as customers for correspondent account purposes that are not treated as customers for CIP purposes. It will require mutual funds to collect identifying information that they do not currently have on all NSCC member firms' customers to determine whether any of those customers are foreign financial institutions, so that the fund can fulfill the Correspondent Account Rule's requirements. As a result, such an interpretation will result in all of the same unnecessary changes, expenses, and order processing delays that we previously highlighted.¹⁰ Given the Treasury and SEC staff interpretation with respect to the CIP Rule, this cannot be Treasury's intent in adopting the Correspondent Account Rule.

¹⁰ For a complete description of the potential costs involved, see Attachment C, the letter from the Institute to Paul F. Roye, Director of the Division of Investment Management at the SEC, and Charles Klingman, Senior Financial Economist at the U.S. Department of the Treasury, dated June 24, 2003.

Mr. William Langford
February 3, 2006
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Request for Concurrence

For all of the reasons expressed above, we urge Treasury to concur with our view that in the Fund/SERV context, mutual funds establish, maintain, administer, and manage accounts only for NSCC member firms, rather than for the investors that are the firms' customers.

* * * *

Given the April 4th implementation deadline, we respectfully request your earliest possible response. If you have any questions or need additional information, please contact me at (202) 371-5430 or rcg@ici.org.

Sincerely,

Robert C. Grohowski
Senior Counsel – International Affairs

Cc: Hunter Jones, Assistant Director
Office of Regulatory Policy
U.S. Securities and Exchange Commission

Attachments

- A. About the Investment Company Institute
- B. Background on Fund/SERV
- C. Institute Letter on the CIP Rule and Fund/SERV