Independent Directors Council
Promoting Excellence in Fund Governance

ICI Comment Letter on IOSCO Anti-Money Laundering Report, May 2005

May 17, 2005

Philippe Richard
IOSCO Secretary General
Oquendo 12
28006 Madrid
Spain

Re: Public Comment on Anti-Money Laundering Guidance for Collective Investment Schemes

Dear Mr. Richard:

The Investment Company Institute[1] appreciates the opportunity to express its support for the Technical Committee's recent report providing anti-money laundering guidance for collective investment schemes (CIS).[2] The Institute strongly supports effective rules to combat potential money laundering activity in the financial services industry and supports many of the concepts in the report. We commend the Technical Committee on their work in this area.

Despite our general support, we have concerns over three aspects of the report. First, we are concerned that the report overstates, in certain respects, the responsibility of CIS to verify the identity of beneficial owners of accounts held by intermediaries. Second, we are concerned that the report may inappropriately suggest that CIS should be treated like securities firms with respect to the types of information they are expected to collect from investors. We believe it is critical that AML rules applicable to CIS take into account the nature of the fund business and the characteristics that distinguish it from traditional banking and brokerage businesses. This is particularly important with respect to the types of information collected about investors, where funds and securities firms employ significantly different business models. Third, we are concerned that the report is overly prescriptive in the section dealing with the performance of AML responsibilities by other financial institutions or service providers. These comments are explained in greater detail below.

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Verification of Beneficial Owners

The report states that an “open-end CIS has a responsibility for verifying the identity of the investor, and the beneficial owner of the investor when it is apparent that an account is beneficially owned by a party other than the investor.”[3] We do not believe that this standard should be applied in all cases, and we request that IOSCO recognize at least one exception in its final report: purchases of fund shares in the U.S. that are cleared and settled through the National Securities Clearing Corporation’s Fund/SERV system.

The NSCC introduced Fund/SERV in 1986 to electronically connect brokerage firms and other financial institutions with fund families. Its automated process enables thousands of firms to deal with hundreds of fund families offering thousands of funds via a single, standardized clearance and settlement system. More than 65 million mutual fund accounts reside on fund transfer agency systems through the use of the Fund/SERV system, and Fund/SERV processes more than 400,000 transactions daily with a daily value of over six billion dollars.

U.S. regulators have agreed that where NSCC member firms initiate purchases of CIS shares on behalf of investors (the firm’s customers) that are cleared and settled through Fund/SERV, those firms are the CIS’s “customers” and the investors are not.[4] As a result, in the U.S., CIS are not required to verify the identity of the beneficial owners of these accounts, even though it is apparent (to use the term in the IOSCO report) that they are different from the record owners. We believe that this interpretation is both clearly supported by the text of the applicable U.S. AML rules and, more generally, fully consistent with AML regulatory policy. We respectfully request that IOSCO concur with this view in its final report.

Information to be Collected From Investors

The report makes reference to the general “know your customer” procedures that are described in detail in IOSCO’s CIBO Principle 3, which includes “obtaining information about the client’s circumstances, such as financial background and business objectives, in order to develop a business and risk profile and to ensure that transactions being conducted are consistent with that profile (including, where necessary, the client’s source of funds.)” CIBO Principle 3 is applicable to securities firms.

It is unclear whether the report's reference to CIBO Principle 3 suggests that CIS should follow the same model as securities firms. We strongly recommend that IOSCO clarify in the final report that CIS should not.

AML rules applicable to CIS must take into account the nature of the CIS business and the characteristics that distinguish it from traditional banking and brokerage businesses. At least in the U.S., CIS, their underwriters, and their transfer agents typically have no face-to-face contact with investors. Unlike many retail securities firms, a CIS underwriter in the U.S. generally does not make investment recommendations to investors and is not required by U.S. regulators to make suitability determinations with respect to transactions involving CIS shares. As a result, the underwriter often collects only limited information about shareholders.

We urge IOSCO to recognize that CIS have less information available to them in making AML determinations than other types of financial institutions and to encourage IOSCO members to adopt AML rules applicable to CIS that take this operating reality into account. We have asked U.S. regulators to do the same. For example, we have asked U.S. regulators to clearly state that mutual funds are expected to monitor for suspicious activity and file suspicious activity reports based on the information obtained by the fund, its underwriter, or its transfer agent in the normal course of establishing a shareholder relationship or processing transactions.[5]

Delegation of AML Compliance Functions

We are pleased that the report provides that CIS may sub-contract performance of certain AML compliance functions to service providers.[6] We are concerned, however, that the report is overly prescriptive in setting forth how CIS should select and monitor such subcontractors.

As the report notes, a CIS does not relieve itself from liability by sub-contracting AML compliance functions. The retention of liability in this context provides a powerful incentive for CIS to take appropriate steps in selecting a subcontractor and ensuring that it performs as expected. As a result, we do not believe that it is necessary for securities regulators to dictate the terms of the relationship between the CIS and the subcontractor to the level of detail suggested by the report. Accordingly, we strongly recommend that IOSCO use less prescriptive terms in this section of the report.

* * *

The Institute appreciates the opportunity to support IOSCO's work on this topic and to share our concerns. If you have any questions concerning our views or would like additional information, please contact me at (202) 326-5826 or Bob Grohowski at (202) 371-5430.

Sincerely,

Mary S. Podesta
Senior Counsel

ENDNOTES

[1] The Investment Company Institute is the national association of the U.S. investment company industry. Its membership includes 8,512 open-end investment companies (mutual funds), 650 closed-end investment companies, 143 exchange-traded funds, and 5 sponsors of unit investment trusts. Mutual fund members of the ICI have total assets of approximately $7.959 trillion (representing more than 95 percent of all assets of US mutual funds); these funds serve approximately 87.7 million shareholders in more than 51.2 million households.

[2] Anti-Money Laundering Guidance For Collective Investment Schemes , Report of the Technical Committee of IOSCO (Feb. 2005).

[3] See page 11 of the report, under the heading “Responsibility for client identification and verification.”

[4] See the answer to question 2 in the 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) (August 11, 2003).

[5] See Letter from Craig S. Tyle, Investment Company Institute, to Judith R. Starr, FinCEN, dated March 21, 2003. The SAR rule for mutual funds has been proposed, but has not yet been adopted.

[6] See pages 20-21 of the report, under the heading “Sub-contracting to others.”

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