

A mutual fund is typically governed by a board of directors or trustees, which is responsible for overseeing the management of the fund's business affairs. Mutual funds are typically organized and operated by an investment adviser responsible for the day-to-day operations of the fund. In most cases, the investment adviser is a separate and distinct legal entity from the investment company. The investment adviser is primarily responsible for selecting portfolio investments consistent with the objectives and policies stated in the investment company's prospectus. The investment adviser or a third party may provide administrative services to the fund. Mutual funds also employ transfer agents to conduct recordkeeping and related functions.⁸

A mutual fund offers its shares continuously and is required to provide its shareholders the right to redeem at net asset value on a daily basis.⁹ Most mutual funds sell their shares to investors through broker-dealers, banks, and other financial intermediaries.¹⁰ Some funds are sold directly through affiliates of the fund itself. If fund shares are sold through an intermediary, the intermediary may maintain an omnibus account with the fund, in which case neither the fund nor its transfer agent has direct contact with the shareholders. The intermediary receives and processes individual investment and redemption requests from its customers, and has access to individuals' trading activity.

preferred over all other classes or series with respect to assets specifically allocated to that class or series. 17 CFR 270.18f-2. The assets allocated to such a class or series are commonly known as a "portfolio." The series or portfolios of a series company operate, for many purposes, as separate investment companies.

⁸ Transfer agents maintain records of shareholder accounts, calculate and disburse dividends, and prepare and mail shareholder account statements, federal income tax information, and other shareholder notices. Some transfer agents prepare and mail statements confirming shareholder transactions and account balances, and maintain customer service departments to respond to shareholder inquiries.

⁹ Section 5(a) of the Investment Company Act defines an open-end investment company as a management investment company that issues or has outstanding any "redeemable security." 15 U.S.C. 80a-5(a). A redeemable security entitles the holder to receive, upon presentation to the issuer, the holder's approximate proportionate share of the issuer's current net assets, or the cash such share represents. 15 U.S.C. 80a-2(a)(32).

¹⁰ Mutual funds usually offer their shares to the public through a principal underwriter, which is in most cases regulated as a broker-dealer and is subject to rules promulgated by the National Association of Securities Dealers, Inc. With respect to transactions occurring after December 30, 2002, brokers and dealers in securities are required to report suspicious transactions to the Treasury under 31 U.S.C. 5318(g). See 31 CFR 103.19 (suspicious transaction reports by securities brokers or dealers).

Although neither the mutual fund nor its transfer agent necessarily knows the identity of individual investors that hold fund shares through a financial intermediary's omnibus account, the intermediary does have access to that information, and may itself have anti-money laundering responsibilities.¹¹ A foreign broker-dealer without independent anti-money laundering requirements may also maintain omnibus accounts with the fund. This kind of omnibus account falls within the definition of "correspondent account" under section 312 of the Act and as such is subject to due diligence and possibly enhanced due diligence requirements under that section of the Act and implementing regulations.¹²

C. Money Laundering Risks Associated with Mutual Funds

Mutual funds present real opportunities for money laundering. They are widely held, easy to access, and can be redeemed quickly.¹³ Indeed, money market funds, which typically offer check writing privileges, function much like bank checking accounts.¹⁴ But because mutual funds rarely receive from or disburse to shareholders significant amounts of currency, they are not as likely as other types of financial institutions (e.g., banks) to be used during the initial (or "placement") stage of the money laundering process.¹⁵ Money laundering is more likely to occur through mutual funds at the later stages of the money laundering process

¹¹ Broker-dealers in securities and futures commission merchants are subject to the anti-money laundering compliance requirements of the Bank Secrecy Act.

¹² Pursuant to section 312, regulations have been proposed that would require U.S. financial institutions offering correspondent accounts to perform due diligence and, in appropriate circumstances, enhanced due diligence on their correspondents. See 67 FR 37736 (May 30, 2002) and 67 FR 48348 (July 23, 2002).

¹³ Section 22(e) of the Investment Company Act requires a mutual fund to redeem the value of shares within seven days of receiving a redemption request. 15 U.S.C. 80a-22(e).

¹⁴ See Investment Company Act Release No. 17589 (July 17, 1990) (55 FR 30240 (July 25, 1990)).

¹⁵ It is possible that some structuring schemes used in the placement stage will involve monetary instruments such as money orders, and that money launderers could attempt to use mutual funds that accept this form of payment. Although the known experience of depository institutions with significant money laundering is greater than the known experience of mutual funds, this difference may reflect the fact that criminal funds enter mutual funds at a later stage in the laundering process, when those funds are less immediately identifiable than at the placement stage. Past investigative attention, however, has focused more intensively on the "placement" stage of money laundering (especially the suspicious placement into the financial system of large amounts of currency) than on transfers or conversions of illicit funds once they are already in the financial system.

(the "layering" and "integration" stages).¹⁶

The proposed rule contained in this document is just one of several steps taken by the Department of the Treasury to address comprehensively the risk of money laundering through mutual funds. In April 2002, FinCEN issued an interim final rule requiring mutual funds to develop and implement an anti-money laundering program to prevent them from being used to launder money or finance terrorist activities, which includes achieving and monitoring compliance with the applicable requirements of the Bank Secrecy Act and the Department of the Treasury's implementing regulations.¹⁷ In July 2002, the Department of the Treasury and the SEC jointly issued a proposed regulation to require mutual funds to implement reasonable procedures to (1) verify the identity of any person seeking to open an account, to the extent reasonable and practicable, (2) maintain records of the information used to verify the person's identity, and (3) determine whether the person appears on any lists of known or suspected terrorists or terrorist organizations provided to investment companies by any government agency.¹⁸

This notice of proposed rulemaking follows other recent actions that expand the application of requirements that financial institutions report suspicious transactions. For example, since April 1996, rules issued by FinCEN under the authority contained in 31 U.S.C. 5318(g) have required banks, thrifts, and other banking organizations to report suspicious transactions.¹⁹ In collaboration with FinCEN, the federal bank supervisors concurrently issued suspicious transaction reporting rules

¹⁶ "Layering" involves the distancing of illegal proceeds from their criminal source through the creation of complex layers of financial transactions. Money launderers could use mutual fund accounts to layer their funds by, for example, sending and receiving money and wiring it quickly through several accounts and multiple institutions, or by redeeming fund shares purchased with illegal proceeds and then reinvesting the proceeds received in another fund. Layering could also involve purchasing funds in the name of a fictitious corporation or an entity designed to conceal the true owners. Mutual funds could also be used to integrate illicit income into legitimate assets. "Integration" occurs when illegal proceeds appear to have been derived from a legitimate source.

¹⁷ See 76 FR 21117 (April 29, 2002).

¹⁸ See 67 FR 48318 (July 23, 2002). Under the proposed rule, a mutual fund may contractually delegate the implementation and operation of its customer identification program to a service provider such as a transfer agent although the mutual fund would continue to be responsible for its compliance with applicable requirements.

¹⁹ See 31 CFR 103.18 (requiring banks, thrifts, and other banking organizations to report suspicious transactions).