

August 16, 2010

To All Members

AMFI Best Practice Guidelines Circular No.16/2010-11

Risk mitigation process against Third-Party Cheques in mutual fund subscriptions

The Committee constituted by SEBI on 'Operational Risk Issues related to Investor Service processes in Mutual Funds' has given recommendations on select service processes which are not standard across the industry, are ambiguous or are high risk due to higher possibility of errors or frauds. The said report has been forwarded to you vide our email dated July 28, 2010. It was also advised to you that AMFI is working on implementation plan on various recommendations of the committee. In the meantime SEBI has advised AMFI to take immediate steps to implement recommendations of the committee regarding Third-Party Cheques with a view to enhance compliance with AML/KYC requirements as well as to mitigate the risk associated with such transactions.

AMFI Working group, after examining the recommendations, has suggested the following implementation process.

1. Third-Party Cheque by definition:

- a) When payment is made through instruments issued from an account other than that of the beneficiary investor, the same is referred to as Third-Party payment.
- b) It is clarified that in case of payments from a joint bank account, the first holder of the mutual fund folio has to be one of the joint holders of the bank account from which payment is made.

2. Issues:

There are primarily two inherent risks involved in accepting investment money from a person other than the beneficial owner of the investment (referred to as 3rd party):

- a) Fraud risk (using one investor's cheque to fund a different investor's account)
- b) Non-Adherence to PMLA requirements

3. Recommendations:

(A) Not to accept Third-Party cheques:

Asset management Companies (AMCs) should not accept subscriptions with Third-Party payments except in the following exceptional situations:

- a) Payment by Parents/Grand-Parents/related persons on behalf of a minor in consideration natural love and affection or as gift for a value not exceeding Rs.50,000/- (each regular purchase or per SIP installment)
- b) Payment by Employer on behalf of employee under Systematic Investment Plans through Payroll deductions.
- c) Custodian on behalf of an FII or a client.

(B) Documents to be obtained for exceptional cases:

In case of exceptional situations as above, AMCs should have appropriate and adequate controls in place to carry out verification as required under the Prevention of Money Laundering Act (PMLA), which should, inter alia, includes:

- a) Determining the identity of the Investor and the person making payment i.e. mandatory KYC for Investor and the person making the payment.
- b) Obtaining necessary declaration from the Investor and the person making the payment. Declaration by the person making the payment should give details of the bank account from which the payment is made and the relationship with the beneficiary.
- c) Verifying the source of funds to ensure that funds have come from the drawer's account only.

(C) Investors to be persuaded to adopt safe mode of writing cheque:

As a best practice, to avoid fraud, it is strongly recommended that mutual funds should educate investors to make the payment instrument (cheque, demand draft, pay order, etc) favouring "XYZ Scheme A/c First Investor name" or "XYZ Scheme A/c Permanent Account Number" or "XYZ Scheme A/c Folio number".

4. Process to identify Third-Party payments:

The following process is recommended for identifying Third-Party Cheque:

- a) An investor at the time of his/her purchase must provide the details of his pay-in bank account (i.e. account from which a subscription payment is made) and his pay-out bank account (i.e. account into which redemption / dividend proceeds are to be paid). AMCs and R&TAs already have a process of capturing an investor's bank details mandatorily. These details are used for pay-out. It is recommended that the same details also be used for verifying pay-in (i.e. payment of the subscription money). This can leverage on existing processes which verify such bank accounts using a cancelled cheque leaf, bank statement, etc. In case an investor has multiple accounts, he should be encouraged to register them with the AMC. Pay-in from such registered single or multiple accounts can be treated as 1st party payments.
- b) If the subscription is settled with pre-funded instruments such as Pay Order, Demand Draft, Banker's cheque, etc., a Certificate from the Issuing banker must accompany the purchase application, stating the Account holder's name and the Account number which has been debited for issue of the instrument. The AMC/RTA shall check that the funds have been debited from a pre-registered pay in account, or from the account of the first named unit holder.
- c) A pre-funded instrument issued by the Bank against Cash shall not be accepted for investments of Rs.50,000/- or more. This also should be accompanied by a certificate from the banker giving name, address and PAN (if available) of the person who has requested for the demand draft. The AMC/R&TA shall check that the name as per the letter matches with the first named unit holder.
- d) If payment is made by RTGS, NEFT, ECS, bank transfer, etc., a copy of the instruction to the bank stating the account number debited must accompany the purchase application. The AMC/R&TA shall check that the account number mentioned on the transfer Instruction copy is a registered pay-in account or belonging to the first named unit holder.
- e) If aggregated payments are received via Channel distributors, AMCs shall ensure that the settlement model has satisfactory checks and balances against 3rd party payments.

- f) For payments through net banking, AMCs shall endeavour to obtain the details of the bank account debited from the payment gateway service provider and match the same with the registered pay-in accounts. In case it is found that the payment is not made from a registered bank account or from an account not belonging to the first named unit holder, the AMC/R&TA shall reject the transaction with due intimation to the investor.

5. Time Schedule for Implementation:

- a) AMCs shall implement the process as stated in (4) above within 90 days of the issuance of the circular, but in any case, not later than November 15, 2010.
- b) AMCs shall take steps immediately to communicate with investors and distributors and give adequate time for registration of bank accounts.
- c) AMCs shall initiate action to work out and finalize operating modalities with R&TAs for implementation of recommended process.

All AMCs are requested to confirm having noted the contents of this circular for due compliance. They are also advised to put up this circular in the immediate next meeting of their Trustees for information.

With regards,

H. N. Sinor
Chief Executive