Implementation of Preventive Measures for Money Laundering by Attorneys

-Report on Result of Large Law Firm Survey-

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Japan Federation of Bar Associations ("JFBA" hereinafter) has established the Rules Concerning Verification of Client Identity and Retention of Records (the "Rules" hereinafter), requiring its members to implement preventive measures for money laundering including verification of client identity. Article 9 of the Rules requires members to endeavor to implement measures including internal control system to ensure that Attorneys should take Measures for Identity Verification. In 2017, JFBA's Working Group on Anti-Money Laundering conducted a survey on (i) existence of services that is vulnerable to use for money laundering and details of preventive measures when providing such services; and (ii) method of notice/training on the Rules within the law firms, system for enforcing the Rules, and specific method of enforcement of the Rules by each attorney, etc. to investigate the trend among large law firms.

Consequently, this paper reports on the status of internal control system built by large law firms.

I. Survey Respondents

Large law firms are the top ten law firms in terms of the number of attorneys belonging to law firms as of end of March 2017. By sending the survey questions for response and conducting interviews according to the questions, responses were obtained from the ten law firms. The reason for focusing on law firms with large number of attorneys was that they were supposed to engage in the types of transactions that may be used for money laundering, and that they were likely to be building an internal control system to mitigate the risks.

II. Risks Surrounding Law Firms[1]

1. Risks Identified in the National Risk Assessment of Money Laundering and Terrorist Financing

Latest version of the National Risk Assessment of Money Laundering and Terrorist Financing prepared and announced annually by the National Public Safety Commission was announced in November 2017[2] as of September 30, 2018.Seven law firms responded that they engage in legal services with risks identified by the National Risk Assessment of Money Laundering and Terrorist Financing. Services identified as having the risks were services vulnerable to money laundering using corporate status such as establishment or M&A; services related to buying and selling of real estate; services involving management of assets such as cash; and transactions/procedures concerning anti-social forces including organized crime groups. There were no law firms that replied they are engaged in deposit of funds unrelated to legal matters.

2. Risks Not Identified in the National Risk Assessment for Money Laundering and Terrorist Financing

On the other hand, services with money laundering risks that was not identified by the National Risk Assessment of Money Laundering and Terrorist Financing included preparation of trust agreements. This is a service identified in the RBA Guidance for Legal Professionals[3] prepared by the Financial Action Task Force (FATF), an inter-governmental body established to combat money laundering, etc. It was prepared by FATF to analyze the risk of legal professionals becoming entangles in money

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[1] For risks of money laundering in legal practice in Japan (existence and level of risks), refer to "Risk Assessment of Money Laundering in Legal Practice" by Naoto Kasai on page 55-60 of the October 2018 edition of this magazine.

[2]See "National Risk Assessment of Money Laundering and Terrorist Financing" by Kensuke Kawate, page 67-70, August 2018 edition of the magazine for details.

[3]Temporary translation by the Committee on International Criminal Legislation is available on the member's page of JFBA.
(HOME>>forms/manuals(書式・マニュアル)>>Attorney Ethics/Management of Client Information/Deposits(弁護士倫理／顧客情報・預り金等の管理)>>Temporary Translation of Financial Action Task Force (FATF) Risk Based Approach (RBA) Guidance for Legal Professionals(金融活動作業部会(FATF)法律専門家向けリスク・ベース・アプローチ(RBA)ガイダンスの仮訳について))

laundering, and to provide guidance on the risk-based approach ("RBA" hereinafter).

3. Risk Mitigating Factors for International Remittance

Transactions with foreign countries make it difficult to track money laundering compared to domestic transactions due to the difference in legal systems and transaction systems, etc. Following replies were obtained through the survey as the reason for need of international remittance.

(1) The attorney serves as the main counsel hiring a foreign law firm as local counsel, and make payment to the overseas law firm from the total compensation received from the client.
(2) A law suit was filed in Japan on behalf of a foreign company for collection of debt, and funds were transferred to the deposit account specified in the settlement provisions. Fund was transferred to a foreign company after deducting own fees.
(3) Accepted deposit of money from a client residing overseas which was deposited as guarantee for provisional disposition or security for cost of litigation, and after achieving the intended purpose, the money was reclaimed and remitted to the overseas client.
(4) Dividends for shares of Japanese listed company held by a foreign listed company before the central securities depository system was implemented were received by the attorney acting as a standing proxy, who then transmitted the sum to the foreign listed company.

Above stated reasons accords with the following risk mitigating factors that are listed in the RBA Guidance for Legal Professionals and National Risk Assessment of Money Laundering and Terrorist Financing.

- Reputation of the client
- Providing limited legal services in the capacity of a local or special counsel as part of a large scheme;
- Structure of a client or transactions that is clear to the legal professional.
- Transactions in which customer identification measures are secured by laws, etc.

Many of the large law firms require new client to present a reliable reference before accepting instructions, and focus on the reputation of the client among the risk mitigating factors above. For (1) to (4) above, the attorney knows the consideration for the funds, and the "legal professional understands the structure of a client or transaction." This indicates that services requiring overseas remittance are the types with inherent risks, but large law firms engaged in overseas transactions also have

risk mitigating factors that should be taken into consideration.

4. Reality of Potential Risks

Some law firms experienced emergence of potential risk in the following manner.

(1) A prospective client made an inquiry without any reference. A Japanese company wished to make remittance to a foreign company, inquiring if the payment can be made through the law firm for the purpose of credit enhancement. The law firm was not familiar with content of the business of the Japanese company. The transaction was considered likely to involve money laundering and the instruction was declined.
(2) Instructions were declined for consultation on operating a business subsequent to transfer of money to Japan through a third party; and on regulatory restrictions on remittances, etc.

Common thread for these cases is that an international remittance is required, and that there has been no prior relationship with the prospective client. In these examples, the attorney who received the instruction declined to even listen to the details of the instruction considering the likelihood of money laundering based on their experience.

III. Risk Management and Building an Internal Control System

The Committee of Sponsoring Organizations of the Treadway Commission ("COSO") released the Internal Control - Integrated Framework ("COSO Framework") to enable organizations to effectively and efficiently develop systems of internal control that mitigate risks to acceptable levels, and support sound decision making and governance of the organization. What framework has been established to manage the risks identified in "II" above, and to accurately take measures for identity verification, etc. How effective is it as an internal control system? Using the five components of COSO Framework, i.e., control environment, risk assessment, control activities, monitoring, and information and communications, measures taken by the law firms will be reviewed for each component[4].

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[4] See "Internal Control - Integrated Framework, New Edition (COSO　内部統制の統合的フレームワーク　新装版)" (JICPA Press, 2016) Translation Supervisor: Shinji Yada, Junya Hakoda; Translated by New COSO Working Group, Research Japan Internal Control Research Association for the five components of internal control.

1. Control Environment

Following activities are carried out to create an environment that prevents manifestation of risks.

(1) Communication of the Rules

Nine law firms were confirmed to communicate the Rules.

(2) Preparation and communication of internal rules on money laundering

In addition, some law firms have prepared internal rules and manuals on money laundering. As a method for communication, many are using intranet and to-all e-mails, and in one case, a portal site for relevant information was created.

(3) Training

Many law firms held explanation sessions and trainings. Scope of attendants ranged from (in order of narrow to wide scope) partners with authority to accept instructions and his/her secretaries; manager of administrative staffs; all attorneys; and all staffs.

(4) Establishment of Responsible Department

There was an example that a committee ("Internal Control Committee" hereinafter) was established as a department responsible for anti-money laundering. Internal Control Committee has a secretariat which leads preparation of the manual and holds explanation sessions. In case strict client management is required, the manual states that approval by the Internal Control Committee is necessary. Without its approval, new transactions cannot be registered, and invoices cannot be issued.

2. Risk Assessment

With respect to the method of assessment of risks, there was an example that the attorney accepting the transaction makes decisions referencing the Rules and National Risk Assessment of Money Laundering and Terrorist Financing.

3. Control Activity

Client identity verification and record retention are the core of prevention of attorney's involvement in money laundering. Attorneys are obligated to conduct client identity verification and record retention in certain cases under the Rules.

(1) Tools for Determination on Need for Client Identity Verification and Record Retention

Following examples were given as tools for determining whether there was need for client identity verification and record retention.

(i) Original manual and check sheet prepared by the law firm
(ii) Establishing Database (DB) for managing transactions and clients, and data entry is necessary for accepting transactions. Client identity verification data is a required field to complete the entry.
(iii) A framework where responsible department determines whether there is need for client identity verification and record retention simultaneously with the conflict checking for all new transactions.
(iv) A framework with uniform requirement to obtain certificate of registered information for domestic corporations
(v) A framework with uniform requirement to obtain client identity verification documents regardless of corporation or natural person

(2) Selection of Method for Client Identity Verification

Methods for client identity verification include strict, regular, and simplified methods. There was a case requiring statement of specific grounds when a simplified method is to be used based on determination that "the purpose of the instruction is not likely involving a transfer of criminal proceeds" (Item 4, Paragraph 3, Article 2 of the Rules).

(3) Efforts to Instruction Cooperation by the Client

As an effort to obtain cooperation by the client, there was an example of engagement letter template which stated that the law firm can request documents for the purpose of client identity verification, and that the client shall notify of any change in client identity information.

(4) Control Activities other than Client Identity Verification and Record Retention

Following is an example of a framework for reviewing whether money laundering is involved regardless of need for client identity verification and record retention.

(i) Internal Control Committee secretariat uses a database to investigate the likelihood of clients being anti-social forces or foreign PEPs. If there is information indicating slightest likelihood, the attorney in charge is contacted to obtain confirmation.
(ii) Designated department performs identity check at time of acceptance of

instructions.

(iii) Acceptance of instructions requires interview at the office. At the interview, ask questions to determine whether the instruction is related to money laundering and obtain information depending on the attribute of the client.

Database used for client attribute verification included domestic and overseas database as well as "Public Reference Data at Time of Contracts (*Keiyaku-ji sankou kouhyou data*)" by Tokyo Center for Removal of Criminal Organizations.

(5) Anti-social Forces Clauses

Many law firms decline acceptance of instructions from organized crime groups regardless of money laundering intentions, and responses on questions concerning anti-social forces included the following:

(i) At the request from a client, a clause on "Representation and Guarantee Concerning Anti-social Forces" has been added to the engagement letter template.

(ii) Prospective client is confirmed not to be antisocial forces at the stage of consultation appointment. Explanation is given that the law firm will resign from representation if the client is found to be antisocial forces after accepting the instruction.

(iii) A provision based on the antisocial forces elimination clause published by the Tokyo Center for Removal of Criminal Organizations is included in the engagement letter template.

(iv) The client is requested to represent and warrant that the legal matter is not related to money laundering. Execution of an amended template requires prior approval by the Internal Control Committee.

4. Monitoring

(1) IT System and Database

Many law firms have built a system to monitor the status of activities for preventing manifestation of risks and to capture the number of client identity verification/record retention. Some law firms used physical case files to manage the client identity verification and its records, but many manage the information on transactions and clients using an IT system and database. Some examples included a column for "registration on checking status for need for client identity verification" in the transaction registration system; and retention of scanned data of client identity verification documents on the client information management system.

(2) All Transaction Management Rules

Law firms that have introduced such IT system have rules that require registration of all newly accepted transactions on the IT system.

(3) Internal Audit

Following responses were given on the status of internal audit to check that need for client identity verification/record retention was being met. There are actual examples of internal audits and scheduled audits.

(i) Dedicated department checks the document requirements as necessary.
(ii) There is no independent audit department, but there is a system for checking the status of client identity verification documents, ensuring confirmation and providing reminders.
(iii) Global headquarters perform confirmation and requests confirmation by the Japanese office.

5. Information and Communication

Risk management system must have a framework for gathering and communicating necessary information. Many law firms have built a framework for gathering and communicating necessary information with transaction database using IT systems. Large law firms have implemented visualization of information, and some had monitoring systems in place.

6. Summary

Large law firms are endeavoring to build internal control system from the perspective of managing the risk of money laundering, and they are internal control systems that enable review of effectiveness against the COSO framework components.

IV. Conclusion

The survey indicated that large law firms do engage in the type of transactions that are vulnerable to be used for money laundering, but that they are considering risk mitigation factors, and declining high risk transactions. They are also making efforts to build internal control system from risk management perspectives. All members, regardless of the size and services provided by the law firm, are encouraged to consult with these efforts from the perspectives of effective risk management in taking measures required by Article 9 of the Rules.