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AMERICAN BAR ASSOCIATION

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December 16, 2011

The Honorable Joseph Lieberman
Chairman
Committee on Homeland Security
and Governmental Affairs
United States Senate
Washington, D.C. 20510

The Honorable Susan Collins
Ranking Member
Committee on Homeland Security
and Governmental Affairs
United States Senate
Washington, D.C. 20510

Re: S. 1483, the "Incorporation Transparency and Law Enforcement Assistance Act"

Dear Chairman Lieberman and Ranking Member Collins:

On behalf of the American Bar Association (ABA), which has almost 400,000 members, I write to express our serious concerns regarding S. 1483, the "Incorporation Transparency and Law Enforcement Assistance Act."

The ABA supports all reasonable and necessary domestic and international efforts to combat money laundering and terrorist financing and has worked diligently with the rest of the legal community, federal and international law enforcement authorities, and the states to advance those reforms. At the same time, we believe that federal legislation like S. 1483 is unjustified and would be counterproductive. In particular, the ABA opposes the proposed regulatory approach set forth in S. 1483 that would superimpose new federally mandated requirements on existing state company formation practices and regulate many practicing lawyers and law firms as "formation agents" subject to the bill's beneficial ownership mandates. The ABA also opposes those provisions in S. 1483 that would regulate lawyers and law firms as "financial institutions" under the Bank Secrecy Act. By subjecting lawyers to new federal anti-money laundering (AML), combating the financing of terrorism (CFT), and suspicious activity reporting (SAR) requirements under that Act, the bill would undermine the attorney-client privilege, the confidential client-lawyer relationship, and traditional state court regulation of lawyers. For all these reasons, as more fully explained below, the ABA urges you and your Committee colleagues to oppose the legislation.

Ongoing Legal Profession, International and State Reforms are Most Effective

Over the past several years, the ABA has reached out to and supported efforts by the legal profession, international organizations, and the states to fight money laundering and terrorist financing in ways that minimize the impact on the client-lawyer relationship, the U.S. economy and state regulators. Towards that end, the ABA worked closely with a number of specialty bar associations to develop and promote the "Voluntary Good Practice Guidance for Lawyers to Detect and Combat Money Laundering and Terrorist Financing" (Voluntary Guidance).

The Voluntary Guidance, which is based on the principle that the risks posed by certain types of clients and matters are far greater than those posed by others, allows U.S. lawyers to combat money laundering and terrorist financing by taking prudent, proportional, risk-based steps tailored to the individual situation rather than adhering to a burdensome and rigid “one-size-fits-all” approach. This voluntary, legal profession-initiated effort will help lawyers to effectively combat money laundering and terrorist financing, while still complying with their existing court-imposed ethical duties and other legal obligations. Since the ABA House of Delegates adopted the Voluntary Guidance in August 2010, the ABA has worked diligently to educate lawyers, judges, state and local bars, and the general public regarding the problem of money laundering and the benefits of following the Voluntary Guidance and has kept key leaders of the Committee and their staff, as well as various key federal agencies, apprised of its extensive efforts in this regard.¹

In addition to the Voluntary Guidance, the ABA and numerous other relevant law societies and bar associations from around the world have actively engaged with the intergovernmental body known as the Financial Action Task Force on Money Laundering (FATF) in a collaborative effort to update and further refine the existing international anti-money laundering and counter terrorist financing standards known as the “40+9 Recommendations.” As part of that engagement, the ABA filed four separate comment letters with the FATF² earlier this year encouraging it to preserve the “risk-based” approach of the existing standards and to avoid imposing any unworkable or burdensome new beneficial ownership or other “rules-based” reporting requirements on the legal profession or the private sector.

The ABA also has been working closely with the states’ secretaries of state, the Treasury Department, and other entities on alternative solutions to the problem of money laundering and terrorist financing that would not require new federal legislation or regulations. For example, substantive law groups within the ABA have developed proposals that would require companies to collect, maintain, and disclose more information regarding their incorporators, officers, directors, and shareholders in order to provide additional useful tools to law enforcement officials, but within the existing state company formation system. These proposals would aid law enforcement without creating unnecessary new federal mandates that would preempt or interfere with the confidential client-lawyer relationship or traditional state business formation practices.

¹ The ABA’s April 27 letter to the Senate Homeland Security and Governmental Affairs Committee’s Permanent Subcommittee on Investigations outlining our efforts to promote the Voluntary Good Practice Guidance for Lawyers to Detect and Combat Money Laundering and Terrorist Financing, and the full text of the Guidance, is available at http://www.americanbar.org/content/dam/aba/uncategorized/2011/2011apr27_gatekeepers_l.authcheckdam.pdf

² The ABA’s January, June, September, and December 2011 comment letters to the FATF are available at these links: http://www.americanbar.org/content/dam/aba/publishing/criminal_justice_section_newsletter/crimjust_taskforce_abares_ponsetofatfconsultationpaper.authcheckdam.pdf, http://www.americanbar.org/content/dam/aba/uncategorized/2011/2011jun17_gatekeepero_l.authcheckdam.pdf, http://www.americanbar.org/content/dam/aba/uncategorized/2011/gao/2011sept16_gatekeep_l.authcheckdam.pdf and http://www.americanbar.org/content/dam/aba/uncategorized/2011/gao/2011dec13_gatekeeperregandtheprofessiontf_l.authcheckdam.pdf.

The Beneficial Ownership Requirements of S. 1483 are Burdensome, Costly, and Unworkable

The ABA is encouraged by the various proposals described above, but the Association has serious concerns regarding federal legislative proposals like S. 1483 that would impose costly and unnecessary new regulatory burdens on legitimate businesses and states by requiring all states to obtain “beneficial ownership” information on corporations and limited liability companies (LLCs), keep that information current, and make it available to law enforcement authorities. In our view, the imposition of a new federal regulatory regime focused on beneficial ownership information is not workable, would be extremely costly, and would place onerous burdens on state authorities and legitimate businesses at a time when the U.S. financial system and the domestic economy are under severe stress.

The bill would require state agencies to collect extensive beneficial ownership information on literally millions of legitimate businesses throughout the country. On a practical level, this would require state regulators to adopt significant and expensive hardware and software changes, including the creation of a parallel record keeping system consisting of public and non-public information. This regulatory burden, coupled with a vague, unwieldy, and unworkable definition of “beneficial ownership,” would sow confusion into the formation process and would not enhance the bill’s stated goal of fighting money laundering and terrorist financing.

Although the ABA recognizes the need to improve company formation processes and increase the visibility of persons forming nonpublic entities in the United States, federal legislation designed to regulate business entity formation practices and procedures is unjustified and is not an effective means for addressing the threat of money laundering and terrorist financing activities.

By Seeking to Regulate Lawyers as Formation Agents and Financial Institutions, the Legislation
Would Improperly Impinge on the Regulatory Authority of State Supreme Courts
Over the Legal Profession

The ABA further opposes S. 1483 to the extent that it that would establish a new class of financial institution known as “formation agents” and then subject those agents to the costly and burdensome new beneficial ownership reporting requirements under the bill and to extensive new regulation under the Bank Secrecy Act and other federal AML and CFT laws. Because many lawyers assist clients in forming corporations and LLCs—and thus would be deemed to be formation agents under the legislation—Section 3 of the bill would require the lawyers to gather and maintain extensive beneficial ownership information on the companies they help create and make the information available to law enforcement authorities. In addition, by including lawyers under the definition of formation agents and amending the Bank Secrecy Act to add formation agents to the list of entities deemed to be “financial institutions” regulated by the Act, Section 4 of the legislation would effectively impose stringent AML and CFT compliance requirements on the legal profession and regulate many lawyers as though they were banks.

Lawyers and law firms are not “financial institutions” as that term has been interpreted and thus should not be regulated as such. Although the practice of law creates a confidential, fiduciary relationship between clients and their lawyers, banks and other financial institutions typically engage in arms-length business transactions with their customers. The fiduciary and confidential

relationship between lawyers and their clients has long been appropriately subject to the regulatory authority of the states' highest courts of appellate jurisdiction. By contrast, financial institutions typically are not subject to state-enforced rules of professional conduct analogous to the court-imposed ethics rules governing lawyers. Regulating lawyers as financial institutions also is improper and makes no sense given the other obvious distinctions between large financial institutions, the resources they have at their disposal, and the role they play in handling monetary transactions, as compared to sole practitioners and small and medium law firms—which comprise the vast majority of the legal profession. Therefore, it is unreasonable to impose both beneficial ownership and AML and CFT reporting requirements on lawyers as though they were financial institutions.

The Limited Attorney Exemption in Section 4(b)(3) is Inadequate and Would Harm Clients

Section 4(b)(3) of S. 1483 would exempt attorneys and law firms from the definition of “formation agent” for AML and CFT purposes when they use paid formation agents operating in the U.S. to form corporations or LLCs for their clients. Although the exemption may have been designed to address concerns previously expressed by the legal profession, it nonetheless is inadequate for several important reasons.

First, the exemption applies only to the definition of formation agent under Section 4 of the bill dealing with “Anti-Money Laundering and Anti-Terrorist Financing Obligations of Formation Agents.” Therefore, even when a lawyer uses a paid formation agent to help a client form a corporation or LLC, the lawyer would still be deemed to be a formation agent under Section 3 of the bill and hence would be subject to the costly and burdensome beneficial ownership reporting requirements contained in that section.

Second, the exemption is inadequate with regard to the AML and CFT requirements of Section 4 because it would require lawyers to outsource an important and legitimate practice of law activity to non-lawyers in order for lawyers to be exempt from these requirements. Many states have long considered the preparation of articles of incorporation and other documents necessary to establish a corporation for another to constitute the practice of law, which, in turn, can only be legally performed by licensed lawyers.³ This is because the formation of a corporation necessarily involves the giving of legal advice relative to the rights and obligations of those involved, and the act of forming a corporation requires the knowledge, background, and training of a lawyer for its proper performance.⁴ Therefore, by pressuring lawyers to outsource their clients' corporate

³ For example, the Florida Supreme Court has consistently held that the preparation of corporate charters, articles of incorporation, bylaws and other corporate formation documents is part of the practice of law and can only be legally performed by licensed attorneys. See *The Florida Bar v. Town*, 174 So.2d 395 (Fla. Sup. Ct. 1965), *The Florida Bar v. Keehley*, 190 So.2d 173 (Fla. Sup. Ct. 1966), and *The Florida Bar v. Arango*, 461 So.2d 932 (Fla. Sup. Ct. 1984), *cert denied*, 472 U.S. 1003 (1985). In addition, other state supreme courts, including those in Ohio, Iowa, Colorado, and North Dakota, have reached the same conclusion. See *Columbus Bar Association v. Verne*, 788 N.E.2d 1064 (Ohio Sup. Ct. 2003), *Committee on Professional Ethics v. Gartin*, 272 N.W.2d 485, 492 (Iowa Sup. Ct. 1978), *People v. McClellan*, 434 P.2d 126 (Colo. Sup. Ct. 1967) and *Application of Christianson*, 215 N.W.2d 920 (N.D. Sup. Ct. 1974).

⁴ See, e.g., *The Florida Bar v. Town* at 397 and *Application of Christianson* at 923 (citing *Cain v. Merchants Natl. Bank & Trust Co. of Fargo*, 268 N.W. 719 (N.D. Sup. Ct. 1936)).

formation needs to non-lawyers, Section 4(b)(3) may cause lawyers to improperly aid non-lawyers in the unauthorized practice of law, in violation of the lawyers' ethical and professional duties.⁵

Even if Section 4(b)(3) were interpreted to exempt lawyers who prepare the necessary incorporation or other company formation documents and then use an outside formation agent to file or process the documents, the exemption remains problematic because it would impose substantial additional costs on clients. S. 1483 would require all non-exempt formation agents to gather and maintain extensive beneficial ownership information regarding the companies they help to create and would also force those agents to comply with the extensive AML requirements of the Bank Secrecy Act. Because the cost of complying with these mandates likely will be substantial, formation agents will have to charge companies much higher fees to provide their services, even if their role is largely clerical or procedural. Therefore, because lawyers will be exempt under Section 4(b)(3) only if they agree to outsource these services to outside formation agents—and thereby force their clients to pay substantial additional fees to those agents as the price for the lawyer's exemption—the conditional nature of the exemption will often create a conflict of interest between the clients and their lawyers.

The Legislation Could Force Lawyers to Violate Client Confidentiality

The ABA further objects to the legislation because in the absence of an effective attorney exemption, Section 4 of the bill could potentially impose SAR requirements on the legal profession by requiring lawyers to report to governmental authorities any suspicion that their clients may be engaging in money laundering or terrorist financing activity. If adopted, these SAR requirements would compel lawyers to report confidential client information to governmental authorities, a result plainly inconsistent with their ethical duties and obligations established by the state supreme courts that possess the authority to license, regulate and discipline lawyers.⁶ Requiring lawyers to report such information to the government would also seriously undermine the attorney-client privilege and the confidential client-lawyer relationship by discouraging the full and candid communications between clients and their lawyers that are essential to the lawyer being able to provide the client with effective legal representation.

Conclusion

The American Bar Association appreciates the Committee's efforts to combat money laundering and terrorist financing activities. The ABA remains opposed to federal legislation such as S. 1483, but we will continue to keep the Committee apprised of our ongoing efforts to disseminate the

⁵ ABA Model Rule of Professional Conduct 5.5(a) dealing with "Unauthorized Practice of Law" states that "a lawyer shall not practice law in a jurisdiction in violation of the regulation of the legal profession in that jurisdiction, or assist another in doing so." (italics added)

⁶ Imposing SAR requirements on lawyers directly undermines ABA Model Rule of Professional Conduct 1.6 dealing with "Confidentiality of Information" and with the many binding state rules of professional conduct that closely track the ABA Model Rule. The ABA Model Rule states that "a lawyer shall not reveal information relating to the representation of a client unless the client gives informed consent..." or unless one or more of the narrow exceptions listed in the Rule is present. See ABA Model Rule 1.6, and the related commentary, available at http://www.americanbar.org/groups/professional_responsibility/publications/model_rules_of_professional_conduct/rule_1_6_confidentiality_of_information.html See also Charts Comparing Individual Professional Conduct Rules as Adopted or Proposed by States to ABA Model Rules, available at http://www.americanbar.org/groups/professional_responsibility/policy.html.

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Voluntary Guidance to lawyers, courts, and the entire legal profession and to assist the FATF to further refine its existing international anti-money laundering and counter-terrorist financing standards. In addition, the ABA will continue to support efforts by states to counter these illegal activities in ways that minimize the impact on our economy, on traditional state regulation of the business formation process and the legal profession, and on the confidential client-lawyer relationship.

Thank you for considering our views on these important issues. If you have any questions regarding the ABA's position on the legislation or any other matter, please contact ABA Governmental Affairs Director Thomas Susman at (202) 662-1765 or ABA Senior Legislative Counsel Larson Frisby at (202) 662-1098.

Sincerely,

A handwritten signature in black ink, appearing to read "Wm. T. Robinson III", enclosed within a large, loopy circular flourish.

Wm. T. (Bill) Robinson III

cc: Members of the Senate Homeland Security and Governmental Affairs Committee