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Ministry of Finance

Foreign Exchange Inspection Manual

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To: Senior Foreign Exchange Examiners
Foreign Exchange Examiners

From: Zenbei Mizoguchi, Director of International Bureau, Ministry of Finance

Re: Establishment of Foreign Exchange Examiners' Manual

One of the main tasks of the international community since the simultaneous terrorist attacks on the United States on September 11, 2001 has been to strengthen measures against terrorist funding. In cooperation with the international community, Japan has not only successively implemented measures such as the freezing of assets of the Taliban and their associates and terrorists, etc. based on the Foreign Exchange and Foreign Trade Control Law (Law No. 228 of 1949; henceforth 'Foreign Exchange Law'), but has also improved its domestic laws by partially revising the Foreign Exchange Law for terrorist funding countermeasures and by enacting the Law on Customer Due Diligence with Customers by Financial Institutions, etc. (Law No.32 of 2002; henceforth 'Customer Due Diligence Law').

Since economic sanctions such as asset freezing are carried out through international cooperation, Japan needs to implement them without fail. Further, financial institutions, etc., are required to perform customer due diligence duties fairly in accordance with recent revisions of the Foreign Exchange Law in order to ensure the effectiveness of measures such as asset freezing. To ensure the effectiveness of the provisions of this Foreign Exchange Law and the Customer Due Diligence Law (henceforth 'Foreign Exchange Laws and Ordinances'), it is anticipated that we shall inspect the system of internal controls in financial institutions, etc. for compliance with the Foreign Exchange Laws and Ordinances and that we shall do hands-on checks of whether or not there are examples of transactions or conduct, etc. in foreign exchange services or other transactions or conduct to which the Foreign Exchange Laws and Ordinances apply that breach the Foreign Exchange Laws and Ordinances. It is also anticipated that we shall fully demonstrate their functions that fulfill a key role in on-site inspections in accordance with the provisions of Article 68.1 of the Foreign Exchange Laws and Ordinances under which we can inspect the system of internal controls in financial institutions, etc. for compliance with the Foreign Exchange Laws and Ordinances and in on-site inspections in accordance with the provisions of Article 9.1 of the Customer Due Diligence Law (limited to the matters pertaining to the financial institutions, etc., listed in Article 14(xiii) of the Customer Due Diligence Law) (henceforth 'foreign exchange inspections').

The partial revision of the Foreign Exchange Law and the enforcement of the Customer Due Diligence Law provide an opportunity to establish a Foreign Exchange Inspection Manual, as set out in the attachment, with administrative particulars relating to the inspection items and methods, etc. of foreign exchange inspections based on the provisions of Article 19 of the Foreign Exchange Inspection Rules (Ministry of Finance Special Instruction No.3 of 1998). We want to conduct inspections using this manual. Our aims in establishing this manual are:

- (1) To clarify assessment standards for inspections by specifically pointing out the basic approach, etc. of the regulatory authorities to foreign exchange inspections and a checklist of inspection items from the viewpoint of government transparency and accountability;
- (2) To encourage the development of internal controls to ensure that financial institutions comply with the Foreign Exchange Laws and Ordinances through the publication of checklists for the inspection items of foreign exchange inspections; and
- (3) To enhance efficiency as well as to strive for qualitative improvements in foreign exchange inspections, and to ensure homogeneity of inspections conducted by this Ministry and the local finance bureaus.

The Foreign Exchange Inspection Manual will be established, and shall apply to foreign exchange inspections started as from January 6, 2003.

Since, however, financial institutions, etc., need sufficient time to develop a system of internal controls of compliance with the Foreign Exchange Laws and Ordinances, for foreign exchange inspections starting between January 6 and June 30, 2003, all circumstances will be taken into consideration in relation to matters concerning the system of internal controls (including those relating to compliance with individual provision of the Foreign Exchange Laws and Ordinances), and even if the development of the system is not complete, we shall listen to policies and plans about future developments, and we shall desist from inducing financial institutions, etc. to construct a system of internal controls in line with the approach of the Foreign Exchange Inspection Manual.

In addition, the items in "III. Other" in Exhibit 3, the Checklists Pertaining to State of Compliance of Financial Institutions, etc. with Foreign Exchange Laws and Ordinances concerning Customer Due Diligence Duties, etc., of the Foreign Exchange Inspection Manual, shall not apply until November 15, 2003.

Attachment

Foreign Exchange Inspection Manual

1 Purpose

In accordance with the provisions of Article 19 of the Foreign Exchange Inspection Rules (Ministry of Finance Special Instructions No.3 of 1998; henceforth 'Instructions'), the Foreign Exchange Inspection Manual sets out administrative particulars concerning inspection items and inspection methods of on-site inspections based on the provisions of Article 68.1 of the Exchange and Foreign Trade Control Law (Law No. 228 of 1949; henceforth 'Foreign Exchange Law') and of on-site inspections based on the provisions of Article 9.1 of the Law on Customer Due Diligence with Customers by Financial Institutions, etc. (Law No.32 of 2002; henceforth 'Customer Due Diligence Law') (limited to items pertaining to the financial institutions, etc. listed in Article 14 (xiii) of the Customer Due Diligence Law) (henceforth 'foreign exchange inspections').

2 Basic Approach to Implementing Inspections

(1) When implementing inspections, note the following points in particular, in addition to those points set down in the Instructions:

(i) Implement effective inspections through methods, etc. that are efficient for the type of operation of the party being inspected and for the current status, etc. of the operation;

(ii) Implement systematic inspections by prioritizing and pursuing efficiency in inspections in order to achieve the maximum inspection effectiveness with the minimum number of staff and budget.

(2) As well as conducting separate checks on whether or not transactions or conduct pertaining to foreign exchange services or other transactions or conduct to which the Foreign Exchange Law applies (henceforth 'transactions or conduct inspected') comply with the relevant provisions of the Foreign Exchange Law or Customer Due Diligence Law (henceforth 'Foreign Exchange Laws and Ordinances'), we check whether a system of internal controls has also been established to ensure compliance with the Foreign Exchange Laws and Ordinances, and we encourage the party being inspected to voluntarily establish a system of compliance with the Foreign Exchange Laws and Ordinances.

3 Inspection Items

(1) Foreign exchange inspections shall be conducted by classifying inspection items as indicated below:

(i) Compliance with Foreign Exchange Laws and Ordinances on economic sanctions such as asset freezing

a. Clearance by Minister of Finance in accordance with the provisions of the instructions based on the provisions of Articles 16.1, 21.1, or 25.4 of the Foreign Exchange Law (including compliance with the terms for clearance based on the provisions of Article 67.1 of the same law)

b. Performance of the duty to check in accordance with the provisions of Article 17 of the Foreign Exchange Law

(ii) Compliance of financial Institutions, etc. with Foreign Exchange Laws and Ordinances on customer due diligence duties, etc.

Performance of customer due diligence duties and the duty to create customer due diligence records, etc., in accordance with the provisions from Articles 18.1 through 18.3, 18-3, 18-5, 22-2, and 22-3

Note: The performance of customer due diligence duties, etc. in accordance with the provisions of Article 3.1 or 3.2 of the Customer Due Diligence Law concerning the financial institutions, etc. listed in Article 2(xxxviii) of the same law, the performance of customer identification record creation duties, etc. in accordance with the provisions of Article 4 of the same law, and the performance of transaction record creation duties, etc. in accordance with the provisions of Article 5 of the same law shall all be inspected.

(iii) Compliance with Foreign Exchange Laws and Ordinances on accounting, etc. for special international financial transaction accounts

Compliance with items relating to the accounting, etc. for special international financial transaction accounts in accordance with the provisions of the instructions based on the provisions of Article 21.4 of the Foreign Exchange Law

(iv) Compliance with the Foreign Exchange Laws and Ordinances concerning the items listed in (i) through (iii)

(v) Performance of the duty to register in accordance with the provisions of Article 55-3.6 of the Foreign Exchange Law (limited to foreign exchange inspections of the registrants specified in Article 55-3.3)

(2) Our intention is to achieve flexible inspections by, for example, setting down that inspections should be conducted by changing the priorities among the inspection item classifications of (1) to suit each individual inspection with a view to achieving effectiveness, prioritization, and efficiency in inspections for the type of operation of the party being inspected and for the current status, etc. of the operation.

4 Inspection Methods

Use the checklists in the Exhibits to check the state of compliance of the inspection items in the classifications listed in 3(1)(i) through (iv) with the Foreign Exchange Laws and Ordinances under the points listed below:

(1) Use the “Checklist for System of Internal Controls as Whole to Ensure Compliance with Foreign Exchange Laws and Ordinances” to check whether or not a system of internal controls has been established to ensure compliance with the Foreign Exchange Laws and Ordinances within the framework of a system of compliance with laws and ordinances by the party being inspected and a system of office work risk management. Identify problem areas in transactions or conduct targeted for individual inspections for compliance with the Foreign Exchange Laws and Ordinances.

(2) Use the “Checklist for Compliance with Foreign Exchange Laws and Ordinances on Economic Sanctions such as Asset Freezing,” “Checklist on Compliance with Foreign Exchange Laws and Ordinances on Customer Due Diligence Duties, etc. of Financial Institutions, etc.,” and “Checklist on Compliance with Foreign Exchange Laws and Ordinances on Accounting for Special International Financial Transaction Accounts” to check the items listed below for the classifications listed in 3(1)(i) through (iii):

(i) Has a system of internal controls been established to ensure compliance with the Foreign Exchange Laws and Ordinances on the transactions or conduct being inspected?

(ii) Do the financial institutions, etc. comply with the Foreign Exchange Laws and Ordinances in the individual transactions or conduct being inspected (field inspections)?

Note: Since it is usually impossible to individually check all the transactions or conduct targeted for inspection, it is justifiable to check transactions or conduct by making an appropriate selection of transactions or conduct within a set period of time (for three years, etc. before the date set as the inspection base date) using a method that can achieve the maximum effect for inspections.

(3) Notes on Use of Checklists in Exhibits

(i) Note that items relating to the system of internal controls, etc. in the checklists in the Exhibits are to be used to identify problem areas in compliance with the Foreign Exchange Laws and Ordinances for the party being inspected and are also to be used for reference when inspecting individual transactions or conduct, and that it is not directly legally binding to achieve these levels.

(ii) The checklists in the Exhibits target all financial institutions, etc., including the overseas branches of Japanese banks and the Japanese branches of foreign banks. Their application to foreign overseas branches, however, is to be judged in light of the relationship between the application of the Foreign Exchange Law and local laws and ordinances and the realities of operations in the said overseas branches.

(iii) The checklists in the Exhibits have been prepared with banks, etc. that handle many foreign remittances and non-resident deposits in mind. When implementing inspections, bear in mind differences in content and levels, etc. in the establishment of systems for compliance with the Foreign Exchange Laws and Ordinances that must be required in accordance with the type of operations of the party being inspected and the current status, etc. operations. The checklists must be applied by fully taking into account the actuality and particularity of the party being inspected.

(iv) The items in the checklists where it has “has it done/does it?” or “is there” are, unless otherwise noted, items that the party being inspected should, as a rule, achieve (minimum standards). Items where it has “is it striving to?” or “it is desirable/it should” are effort items or wish items (best practice).

(v) In the checklists, “board of directors, etc.” includes, besides “board of directors,” the executive board, management committee, and committees or meetings, etc. within the organization of which the participating director is a constituent member.

“Management/manager” refers to senior executives (including directors) that have responsibilities at or above the level of sales managers.

Note that the terms for job titles are different for cooperative society financial institutions.

Exhibits

Checklists

Exhibit 1: Checklist for System of Internal Controls as Whole to Ensure Compliance with Foreign Exchange Laws and Ordinances

Exhibit 2: Checklist for Compliance with Foreign Exchange Laws and Ordinances on Economic Sanctions such as Asset Freezing

Exhibit 3: Checklist on Compliance with Foreign Exchange Laws and Ordinances on Customer Due Diligence Duties, etc. of Financial Institutions, etc.

Exhibit 4: Checklist on Compliance with Foreign Exchange Laws and Ordinances on Accounting, etc. for Special International Financial Transaction Accounts