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SUSPICIOUS ACTIVITY REPORTING: RECENT DEVELOPMENTS AND GUIDANCE ON KEY ISSUES

Federal Authorities Have Taken Steps to Provide Greater Clarity and Consistency in Anti-money Laundering Regulation, Including Release of a New Examination Manual and Revision of Department of Justice Procedures for Criminal BSA Prosecutions. Separately, FinCEN Has Provided Guidance on SAR Issues such as Timing, Corrections and Updates, and Confidentiality.

By Derek M. Bush & Katherine M. Carroll*

In the wake of a series of high-profile criminal and regulatory enforcement cases against banks and heated discussions in the banking community about ambiguous standards, lack of coordination among government authorities and defensive filing of suspicious activity reports ("SARs"),[1] the Financial Crimes Enforcement Network ("FinCEN") and the federal banking agencies have taken a number of steps to provide greater clarity about anti-money laundering ("AML") and Bank Secrecy Act ("BSA") requirements and to improve government coordination. Most significantly, at the end of June, FinCEN and the federal banking agencies released a new BSA/AML Examination Manual as part of a collaborative effort designed to achieve greater clarity and consistency in BSA/AML examinations.[2] Following publication of the new manual, the agencies and FinCEN conducted a series of national conference calls and regional outreach programs to help banks and bank examiners understand its requirements.

In another key development, the Department of Justice announced this summer that it has adopted a new requirement that all criminal prosecutions of financial institutions for BSA violations, including failures to file SARs,

1. *See*, *e.g.*, Douglas N. Greenburg, *Stakes Raised for Banks: The Threat of Criminal Prosecutions for Failing to Report Suspicious Activity*, REV. BANKING & FIN. SERVICES, Feb. 1, 2005, at 27.

*DEREK M. BUSH is a partner and KATHERINE M. CARROLL is an associate at Cleary Gottlieb Steen & Hamilton LLP in Washington, D.C. They advise domestic and international financial institutions regarding U.S. bank regulatory matters. Their email addresses are dbush@cgsh.com and kcarroll@cgsh.com. This article was prepared to provide general information and should not be considered or relied on as legal advice.

2. Federal Financial Institutions Examination Council, BANK SECRECY ACT/ANTI-MONEY LAUNDERING EXAMINATION MANUAL, available at www.ffiec.gov/bsa_aml_infobase/documents/BSA_AML_Man.pdf.

will require approval of department headquarters in Washington ("Main Justice").[3] Previously, prosecutions for criminal money laundering under 18 U.S.C. §§ 1956 and 1957 required Main Justice approval, but prosecutions for criminal violations of the BSA did not (although such crimes are treated as money laundering offenses for other purposes).[4] The Justice Department's change responded to concerns expressed by federal banking agencies, FinCEN and the banking industry that SAR compliance was being "criminalized" and prosecutions were not adequately controlled by Washington or coordinated with the banking agencies with day-to-day supervisory responsibility for the target institutions.[5]

In an era of terrorist threats, continuing money laundering activities and significant public, congressional and prosecutorial scrutiny of BSA failures at banks, monitoring and enforcing BSA compliance has become a top priority of federal banking agencies. In the enforcement area, it is undoubtedly one of the most prominent issues for financial institutions. Senior bank regulatory officials have acknowledged that expectations regarding compliance are simply higher today than they were several years ago. In this context, and following the release of the new Examination Manual, compliance with published regulatory guidance has become all the more important. Given the central role that SARs have played in recent enforcement orders, particular attention should be paid to ensuring that policies and procedures relating to suspicious activity reporting measure up against the standards set forth in the manual. As institutions review their policies and procedures in light of the Examination Manual, they should ensure they take into account other recent guidance not captured in the manual and the lessons of recent

3. *See Money Laundering Amendments to U.S. Attorneys' Manual Ease Some Worries About BSA Prosecutions*, BNA BANKING DAILY, July 14, 2005. The policy was implemented by amending the section of the U.S. ATTORNEYS' MANUAL that specifies the circumstances in which Main Justice approval is required. *See* Dep't. Justice, U.S. ATTORNEYS' MANUAL (Updated 2005), Section 9-103.500, available at www.usdoj.gov/usao/eousa/foia_reading_room/usam/title9/105mcrm.htm.
4. *See*, *e.g.*, U.S. ATTORNEYS' MANUAL at § 9-105.320 (requiring the Attorney General to provide written notice to the relevant bank regulatory authority of both convictions under 18 U.S.C. §§ 1956 and 1957 and convictions under the BSA); 12 U.S.C. § 1818(w) (providing that both convictions under 18 U.S.C. §§ 1956 and 1957 and convictions under the BSA trigger the discretionary authority of the Federal Deposit Insurance Corporation to terminate a bank's deposit insurance).

5. *See*, *e.g.*, *FinCEN in Talks with Justice Department*, BNA BANKING DAILY, March 16, 2005; *Divisions Still Deep on Launder Enforcement: A Sharp Exchange Between Justice and Fed Officials*, AM. BANKER, March 4, 2005.

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enforcement actions concerning some of the thornier questions relating to SAR filings.

BACKGROUND

The BSA, as implemented by FinCEN and federal functional regulators, requires banks and certain other "financial institutions" to file SARs.[6] While certain aspects of the filing requirements differ depending on the type of financial institution involved, generally a financial institution must file a SAR when it knows, suspects or has reason to suspect that a transaction of $5,000 or more (or transactions together aggregating $5,000 or more): (i) involves proceeds of illegal activity, or is intended to hide funds or assets derived from illegal activity; (ii) is designed to evade BSA regulations; or (iii) has no business or apparent lawful purpose or is not the sort in which the customer would normally be expected to engage, and the institution knows of no reasonable explanation for the transaction after examining available facts. Federal banking regulations also require banks to file a SAR if a bank discovers that it has been an actual or potential victim of a crime or was used to facilitate a criminal transaction if: (i) the transactions involved insider abuse with respect to any amount, (ii) the transactions aggregated $5,000 or more and a suspect could be identified or (iii) the transactions aggregated $25,000 and there was no specific suspect. Financial institutions also may voluntarily report suspicious transactions that they believe are relevant to a violation of law or regulation.

IMPORTANCE OF A RISK-BASED APPROACH

The new Examination Manual, related outreach programs, and recent enforcement orders have all emphasized the importance of employing a risk-based approach to monitoring for suspicious transactions. Such an approach should include risk assessments of products and services, customers, and geographic locations. Initial assessments should be updated to account for new products or services, account growth, and mergers and acquisitions and institutions should provide for periodic reassessments. Based on these risk assessments, an institution should develop appropriate policies, procedures, systems and controls to address the risks identified. Enhanced due diligence and monitoring is expected for services, customers, and geographic areas identified as high-risk. The banking agencies and FinCEN have published guidance listing particular products and services, types of customers, and geographic areas that potentially should be classified as high-risk and trigger enhanced scrutiny, and these high-risk categories are reflected in the new Examination Manual. In addition, engagement of more senior levels of management may be appropriate with respect to certain high-risk categories (for example, accounts of foreign political figures).

The compliance program adopted by a financial institution should include four key components: internal controls, independent audit/testing of the program, a qualified BSA compliance officer, and training for the institution's personnel. Recent enforcement orders have highlighted in particular the importance of auditing and testing an institution's AML program. Having a strong program in place helps protect an institution when individual SAR failures are discovered, particularly with respect to potential criminal liability. No system can guarantee that every suspicious transaction will be detected and reported, and institutions that can point to a robust overall program will be regarded more favorably by regulators when a failure does occur.

TIMING OF SAR FILINGS

Uncertainty has persisted in the industry with respect to the deadline for filing a SAR. The regulations state that a SAR must be filed within 30 days of "initial detection of facts that may constitute a basis for filing a SAR," or within 60 days if no suspect could be identified.[7] The uncertainty surrounds when the 30-day (or 60-day) clock is meant to begin. Although the language of the regulation could be read to focus on the detection of the *facts*, rather than the institution's *determination that the facts are suspi-*

6. The BSA authorizes the Secretary of the Treasury to require "financial institutions" to report suspicious activities. To date, regulations have been issued requiring suspicious activity reporting by banks, futures commission merchants and introducing brokers, broker-dealers, money service businesses, casinos and, effective May 2006, insurance companies. *See* 31 C.F.R. §103.17-103.21; 70 Fed. Reg. 66761 (Nov. 3, 2005) (final rule implementing suspicious activity reporting requirements for certain insurance companies). *See also* 67 Fed. Reg. 48318 (July 23, 2002) (proposed rule establishing suspicious activity reporting requirements for mutual funds). Although most of the issues discussed in this article apply to all financial institutions required to file SARs, this article focuses on the requirements for banks (including thrifts), since banks were the subject of the new Examination Manual and most of the recent criminal prosecutions under the BSA involving SAR failures.

7. *See*, *e.g.*, 12 C.F.R. § 208.62(d).

cious, FinCEN guidance has clarified that it is appropriate for organizations to conduct a review of potentially suspicious activity, and that the commencement of such a review is not necessarily indicative of the need to file a SAR. As stated by FinCEN, "[t]he time to file a SAR starts when the organization, in the course of its review or on account of other factors, reaches the position in which it knows, or has reason to suspect, that the activity or transactions under review meets one or more of the definitions of suspicious activity."[8] Thus, FinCEN's guidance provides a basis to conduct an appropriate investigation and start the 30-day or 60-day clock from the time an institution concludes or has reason to suspect that the activity met the standard for filing a SAR. Institutions should bear in mind, however, that although FinCEN acknowledges that a "reasonable review . . . might take an extended period of time," it also recommends that reviews be "expeditious."[9] The regulations also require that any violations requiring immediate attention (such as an ongoing violation) should be reported immediately by phone to the appropriate law enforcement and bank supervisory authority, in addition to the subsequent filing of a written SAR.[10]

In light of FinCEN's guidance, a key aspect of compliance with deadlines for filing SARs involves the implementation of procedures to ensure that an investigation stays on track and is completed expeditiously. Clear assignments of responsibility for an investigation and periodic internal deadlines for consideration of the status of an investigation file are two useful elements that financial institutions with significant numbers of SAR filings may wish to consider. While some professionals have suggested that institutions adhere to an internal "drop dead date" — a date at which the institution will simply file a SAR if the factual picture remains unclear — others (including the authors) are comfortable that the duration of an investigation need not be fixed so long as procedures are followed to prevent an investigation from drifting.

CORRECTING AND UPDATING SARS

Another issue that generates frequent questions relates to financial institutions' obligation to file updates regarding continuing suspicious activity, and the difference between a SAR "correction" and an "update." A financial institution that discovers an error in a previously filed report, or that uncovers additional information or previously undetected suspicious activity relating to a previously filed SAR, should *correct* it by filing a new SAR form and checking Box 1 on the form ("corrects prior report"). Recent FinCEN guidance indicates that financial institutions should correct all errors — even errors that the financial institution may perceive to be immaterial.[11] FinCEN notes that information may seem insignificant to a financial institution but have value to a law enforcement investigation.

Current FinCEN guidance suggests that financial institutions should file *updates* regarding suspicious activity that has continued since the last SAR filing at least every 90 days.[12] Such updates should not be marked as corrections, but the narrative should reference previously filed SARs related to the activity. If the nature of the suspicious activity has changed, however (*e.g.,* the customer was previously making structured withdrawals and then began making suspicious wire transfers), the institution should file a new SAR within the 30-day or 60-day time limit rather than filing a 90-day update. The fact that a financial institution may be aware that law enforcement is conducting an active investigation or has decided not to initiate an investigation does not relieve the institution of its obligation to file a SAR update.[13]

AN EFFECTIVE SAR NARRATIVE

From the perspective of law enforcement, the narrative is generally considered to be the most important element of a SAR. Especially given the large volume of SARs filed, it is seen as critical that the narrative present a complete and clear account to law enforcement of the parties involved, the transaction, and why the activity appeared suspicious. Notwithstanding the fact that FinCEN has published extensive guidance regarding the preparation of SARs and the SAR narrative, including examples of sufficient and insufficient narratives, financial institutions con-

8. FinCEN, ANSWERS TO FREQUENTLY ASKED BSA QUESTIONS, available at www.fincen.gov/reg_faqs.html.
9. *Id.*
10. *See*, *e.g.*, 12 C.F.R. § 208.62(d).
11. *See* FinCEN, THE SAR ACTIVITY REVIEW, Issue 9 (Oct. 2005), at 42.
12. *See* FinCEN, THE SAR ACTIVITY REVIEW, Issue 8 (April 2005), at 31-33.
13. *See* FinCEN, ANSWERS TO FREQUENTLY ASKED BSA QUESTIONS.

tinue to receive criticisms in their examinations for incomplete (or, in some cases, non-existent) SAR narratives.

FinCEN's guidance states that SAR narratives should answer five key questions: *Who* is conducting the suspicious activity? *What* instruments or mechanisms facilitated the suspect transactions? *When* did the suspicious activity occur? *Where* did the suspicious activity take place? *Why* does the institution think the activity is suspicious? To make the narrative as useful as possible, the author should keep in mind a common axiom of effective writing: write for the audience. Keeping in mind the perspective of a law enforcement officer reading the SAR should help an author anticipate what questions law enforcement is likely to have and what further details would be helpful.

CONFIDENTIALITY OF SARS

Federal law specifically prohibits disclosing to any person involved in activity that is the subject of a SAR that the activity has been reported.[14] The purpose of this prohibition is to prevent financial institutions from "tipping off" customers that activity has been reported, which could impair a law enforcement investigation. Federal bank regulations further provide that "SARs are confidential," and require financial institutions subpoenaed or otherwise requested to provide copies of SARs to decline to turn over SARs or any information that would disclose that a SAR has been filed and to inform their federal regulator of the subpoena (a procedure designed to give the regulator an opportunity to intervene to prevent disclosure if necessary).[15] Based on these regulations, courts have consistently upheld the refusal of financial institutions to produce SARs in civil litigation.[16]

In some contexts, the statutory prohibition on disclosure has been interpreted to extend to disclosures that could indirectly result in a subject of a SAR learning that a SAR was filed, and FinCEN's SAR rules suggest that the permissible disclosure of SARs is limited to law enforcement and supervisory authorities.[17] Thus, while the actual statutory prohibition on disclosure to a party involved in the suspicious activity is relatively narrow, its interpretation and implementation have led many to understand it as a much broader prohibition against disclosure. In our view, there should be circumstances in which a financial institution could, consistent with the statutory prohibition, share SAR information in order to further its legitimate AML risk management objectives, so long as it can reasonably ensure that the SAR and its existence will not be disclosed to an individual involved in the underlying activity. Indeed, FinCEN's regulations for certain types of financial institutions expressly permit sharing of SAR information between financial institutions, confirming that the statutory prohibition does not necessarily prohibit such sharing.[18]

A particular context in which this issue arises relates to the ability to share SARs within a corporate group — for example, the ability of a U.S. branch of a bank headquartered outside the United States to share SARs and SAR-related information with its head office, or the ability of a bank to share SARs and SAR-related information with its parent bank holding company. Although there is no formal guidance on this point, FinCEN and the banking agencies have informally indicated that such "vertical sharing" should be permissible.[19] It is less clear, however, whether regulators interpret the statute to allow financial institutions to share SARs and SAR-related information with affiliates "horizontally" — *i.e.*, with companies under common control with the financial institution.

14. *See* 31 U.S.C. § 5318(g)(2).
15. *See*, *e.g.*, 12 C.F.R. § 208.62(j).
16. *See*, *e.g.*, *FDIC v. Flagship Auto Center*, No. 3:04 CV 7233 (N.D. Ohio, May 13, 2005); *Int'l Bank of Miami, v. Shinitzky*, 849 So. 2d 1188 (Fla. 2003).
17. *See*, *e.g.*, 31 C.F.R. § 103.18(e); 31 C.F.R. § 103.19(e). FinCEN guidance also implicitly recognizes that a financial institution may share SARs and SAR-related information with its professional advisors.
18. For example, the FinCEN rule requiring insurance companies to file SARs contemplates an insurance company sharing SAR information with its unaffiliated agents and brokers as long as such sharing does not notify the subject of the SAR that the transaction has been reported. FinCEN rules also allow broker-dealers and futures commission merchants to share SAR information with introducing brokers in order to file joint SARs. *See* 70 Fed. Reg. 66761, 66766 (Nov. 3, 2005) (SAR rule for insurance companies); 68 Fed. Reg. 65392, 65395 (Nov. 20, 2003) (SAR rule for futures commission merchants and introducing brokers); 67 Fed. Reg. 44048, 44052 (July 1, 2002) (SAR rule for broker-dealers).
19. *See*, *e.g.*, Interagency BSA/AML Webcast Outreach Event, Aug. 22, 2005, available at www.visualwebcaster.com/FFIEC/30018/_reg.html.

This issue is especially important for financial services organizations with multiple subsidiaries that share AML compliance resources. For example, one individual may serve as the AML compliance officer with responsibility for SAR filings for both a bank and an affiliated broker-dealer, effectively requiring the sharing of SAR-related information between the two entities. Similarly, there may be circumstances in which a bank and an affiliated broker-dealer need to work together to prepare an effective SAR with a narrative that covers transactions and relationships with both affiliates. Sharing of SAR-related information within a corporate group also can be an important means of facilitating effective group-wide audit procedures and enterprise-wide risk management.

FinCEN is expected to issue written guidance concerning at least one of these issues — the ability of a U.S. branch to share with its head office outside the United States — in the near future. FinCEN's guidance is expected to permit this type of sharing subject to certain cautions regarding confidentiality procedures. Given the questions that have recently been raised about sharing within corporate groups, many in the industry are hopeful that FinCEN will address more broadly the permissibility of vertical and horizontal sharing. As noted above, given the relatively narrow scope of the statutory prohibition, and in view of the potential benefits of SAR sharing within a corporate group, the authors believe that an institution with appropriate group-wide SAR confidentiality safeguards should be permitted to share within a corporate group to further its AML risk management objectives. However, the prevailing uncertainty in this area is likely to persist until FinCEN issues written guidance on the subject.

As these issues continue to be addressed by FinCEN, financial institutions should bear in mind that disclosure of the underlying facts and supporting documentation related to suspicious activity that is reported on a SAR is not prohibited (to the extent their disclosure does not reveal that a SAR has been filed). Thus, a bank or other financial institution should be able to share with its affiliates the fact that it has detected potentially suspicious activity, the names and account numbers of the individuals or entities involved, and a description of the activity. This flexibility, while not a complete solution to the issues identified above, does provide a significant ability to share information for purposes of suspicious activity monitoring within a corporate group.

A final concern that arises in relation to the confidentiality of SARs relates to financial institutions' ability to question their clients regarding potentially suspicious activity. As a legal matter, financial institutions that detect potential suspicious activity should have reasonable latitude to ask the client questions regarding the activity at issue as part of the institution's effort to determine whether the activity is suspicious and should be reported.[20] For example, asking for an explanation for particular transactions or for further information regarding other parties involved in a transaction should be permissible and viewed as part of the institution's monitoring procedures. Indeed, undue restrictions on such communications could lead to unnecessary or ultimately unhelpful SAR filings. At the same time, employees responsible for such interactions with customers should be made aware through training of the importance of not "tipping off" a client that a SAR has been or will be filed and of not making statements that could be viewed as "coaching" a client in how to avoid a reporting requirement. In this regard, the ability to question a customer is likely more limited, as a practical matter, when the potentially suspicious activity involves "structuring" deposits or other cash transactions to avoid the $10,000 trigger for filing Currency Transaction Reports. Such activity is likely to be viewed as inherently suspicious, and the risks of coaching a customer— or being perceived to be doing so — are likely greater.

THE DECISION TO CLOSE AN ACCOUNT

Once a financial institution has concluded that suspicious activity has occurred, should it close the account and terminate its relationship with the customer? What if a second or third SAR is filed on the same customer? Decisions about when and how to close an account in such circumstances continue to be troublesome for financial institutions. FinCEN guidance states that the filing of a SAR alone should not be the basis for terminating a customer relationship; rather, the SAR filing and the facts and circumstances giving rise to the filing are to be evaluated together with all of the other information available to the financial institution in determining whether to close an account.

20. *See*, *e.g.*, FinCEN, GUIDANCE ON PREPARING A COMPLETE & SUFFICIENT SUSPICIOUS ACTIVITY NARRATIVE (Nov. 2003), at 25-26 (citing sufficient SARs that include descriptions of questions posed to customers about their potentially suspicious transactions).

The new Examination Manual states that as part of a complete AML program, institutions should have in place clear policies, approved by the board of directors, specifying the circumstances in which accounts will be closed and relationships terminated. Ultimately, however, decisions about whether to close particular accounts will depend on the facts and circumstances at hand. In some cases, one suspicious transaction may be significant enough to lead an institution to close an account, while in other cases (for example, when there is more uncertainty about the nature of the transactions) several SARs might be filed before an account is closed. In addition, the process of closing an account or otherwise terminating a relationship may be complicated by other legal obligations, such as those arising under account documentation and state laws concerning certain types of banking relationships (*e.g.*, fiduciary accounts).

If an institution decides to close an account, it should proceed carefully, keeping in mind several considerations. First, it is recommended that an institution notify law enforcement prior to closing an account that has generated a SAR filing. If the authorities have an active investigation underway, or plan to initiate one, they may ask the institution to keep the account open to allow them to monitor the customer's activity and gather more information. In that event, institutions should consider documenting the request from law enforcement in case the decision to keep an account open is questioned by an examiner. Second, when closing an account, an institution must take care to formulate its communication with the client so that it is truthful but sufficiently general that it does not tip off the client to the existence of a SAR.[21]

CONCLUSION

In an era of heightened scrutiny and evolving regulatory expectations, suspicious activity reporting is likely to remain a vexing AML compliance issue for banks and other affected financial institutions. The new Examination Manual and changes to the Justice Department's procedures for bringing BSA criminal prosecutions likely will ease some of the pressures that contribute to defensive SAR filing. Continued efforts by regulators to clarify requirements and better coordinate among themselves and with law enforcement officials should facilitate the ability of financial institutions to implement programs that both comply with regulatory expectations and effectively contribute to the fight against money laundering and terrorist financing. At the same time, the high stakes of noncompliance, the rapid pace of regulatory developments and the simple fact that SAR compliance relies on fact-specific judgments that occur every day mean that SAR filings will continue to require significant resources and attention at financial institutions for the foreseeable future. ■

21. Additional considerations apply in the context of loan and other credit accounts for which an institution is required by the Equal Credit Opportunity Act and Regulation B to provide the customer with an adverse action notice stating specific reasons for any adverse action taken. *See* 12 C.F.R. § 202.9.