DISCOVERY ISSUING ARISING FROM THE SUSPICIOUS ACTIVITY REPORT PRIVILEGE

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I. THE SWORD

Discovery regarding red flags of money laundering or fraudulent activity may be critical to developing proof of a broker-dealer's liability in selling away and fraud cases. The duty of financial institutions to detect and monitor suspicious activity arises from the anti-money laundering ("AML") provisions of the Bank Secrecy Act, 31 U.S.C. §5311, *et seq.* FINRA Rule 3310, entitled Anti-Money Laundering Compliance Program, sets forth the requirements of broker-dealers to develop and implement a written AML program designed to monitor the member's compliance with the Bank Secrecy Act and the regulations promulgated thereunder.

FINRA Notice to Members 02-21 and Regulatory Notice 19-18 discuss broker-dealers' obligations under the Bank Secrecy Act and Rule 3310 to identify and report to the Financial Crimes Enforcement Network ("FinCEN") activity that a broker-dealer knows, suspects, or has reason to suspect involves the use of the broker-dealer to facilitate criminal activity. NTM 02-21 and RN 19-18 set forth a litany of red flags of suspicious activity that the member's implemented AML compliance program should be designed to detect.

As part of their obligations under FINRA Rule 3310, the supervisory and registered representative manuals of a broker-dealer invariably set forth the obligation to be cognizant of and report to the AML Compliance Officer ("AMLCO") suspicious or potentially fraudulent or money laundering activity. Broker-dealers also have manuals setting forth the duties of the AMLCO to independently identify suspicious activity and, under appropriate circumstances, make a suspicious activity report ("SAR") to FinCEN.

Discovery of a) manuals setting forth the obligations of registered representatives, branch managers, compliance officers and the AMLCO to identify and report suspicious activity; b) documents relating to the observation of suspicious activity; and c) documents relating to facts that should have raised red flags of suspicious activity may be helpful in establishing that the broker-dealer knew or should have known that its employees or customers were involved in fraudulent activity.

II. THE SHIELD

As a matter of course, broker-dealers may object to discovery requests seeking such discovery based upon a broad extension of the SAR privilege. The SAR privilege is based upon the regulation set forth in 31 C. F. R. § 1023.320, which requires broker-dealers to reports suspicious transactions to FinCEN. Subsection 1023.320(e) provides:

> (e) *Confidentiality of SARs.* **A SAR, and any information that would reveal the existence of a SAR, are confidential and shall not be disclosed except as authorized in this**

paragraph (e). For purposes of this paragraph (e) only, a SAR shall include any suspicious activity report filed with FinCEN pursuant to any regulation in this chapter.

(1) *Prohibition on disclosures by brokers or dealers in securities.*

(i) *General rule.* **No broker-dealer, and no director, officer, employee, or agent of any broker-dealer, shall disclose a SAR or any information that would reveal the existence of a SAR.** Any broker-dealer, and any director, officer, employee, or agent of any broker-dealer that is subpoenaed or otherwise requested to disclose a SAR or any information that would reveal the existence of a SAR, shall decline to produce the SAR or such information, citing this section and 31 U.S.C. 5318(g)(2)(A)(i), and shall notify FinCEN of any such request and the response thereto.

(ii) *Rules of construction.* **Provided that no person involved in any reported suspicious transaction is notified that the transaction has been reported, this paragraph (e)(1) shall not be construed as prohibiting:**

(A) The disclosure by a broker-dealer, or any director, officer, employee, or agent of a broker-dealer, of:

(1) A SAR, or any information that would reveal the existence of a SAR, to FinCEN or any Federal, State, or local law enforcement agency, or any Federal regulatory authority that examines the broker-dealer for compliance with the Bank Secrecy Act; or to any SRO that examines the broker-dealer for compliance with the requirements of this section, upon the request of the Securities Exchange Commission; or

(2) **The underlying facts, transactions, and documents upon which a SAR is based**, including but not limited to, disclosures:

(i) To another financial institution, or any director, officer, employee, or agent of a financial institution, for the preparation of a joint SAR; or

(ii) In connection with certain employment references or termination notices, to the full extent authorized in 31 U.S.C. 5318(g)(2)(B); or

(B) The sharing by a broker-dealer, or any director, officer, employee, or agent of the broker-dealer, of a SAR, or any information that would reveal the existence of a SAR, within the broker-dealer's corporate organizational structure for purposes consistent with Title II of the Bank Secrecy Act as determined by regulation or in guidance.

(2) *Prohibition on disclosures by government authorities.* A Federal, State, local, territorial, or Tribal government authority, or any director, officer, employee, or agent of any of the foregoing, shall not disclose a SAR, or any information that would reveal the existence of a SAR, except as necessary to fulfill official duties consistent with Title II of the Bank Secrecy Act. For purposes of this section, “official duties” shall not include the

> disclosure of a SAR, or any information that would reveal the existence of a SAR, in response to a request for disclosure of non-public information or a request for use in a private legal proceeding, including a request pursuant to 31 CFR 1.11.
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> (3) *Prohibition on disclosures by Self-Regulatory Organizations.* Any self-regulatory organization registered with the Securities and Exchange Commission, or any director, officer, employee, or agent of any of the foregoing, shall not disclose a SAR, or any information that would reveal the existence of a SAR except as necessary to fulfill self-regulatory duties with the consent of the Securities Exchange Commission, in a manner consistent with Title II of the Bank Secrecy Act. For purposes of this section, "self-regulatory duties" shall not include the disclosure of a SAR, or any information that would reveal the existence of a SAR, in response to a request for disclosure of non-public information or a request for use in a private legal proceeding.

31 C. F. R. § 1023.320(e) [emphasis added].

The vast majority of courts have interpreted the SAR privilege to prohibit the disclosure of documents that suggest, directly or indirectly, whether or not a SAR was filed with FinCEN. *In re JPMorgan Chase Bank, N.A.,* 799 F.3d 36, 43 (1st Cir. 2015). Courts will apply the SAR privilege if the documents at issue constitute a SAR or draft SAR, reflect the decision making process as to whether a SAR should be filed, the process of preparing a SAR, or an attempt to explain the content of a SAR. *Id.* at 44. Documents created in the ordinary course of business in monitoring unusual activity (as opposed to documents of an evaluative nature intended to comply with FinCEN reporting requirements), however, should not be subject to the SAR privilege. *Id, at 41*. "Any supporting documentation which would not reveal either the fact that a SAR was filed or its contents cannot be shielded from otherwise appropriate discovery based solely on its connection to an SAR." *Id.* at 44, citing *United States v. Holihan*, 248 F.Supp.2d 179, 187 (W.D.N.Y. 2003).

Broker-dealers require compliance officers, branch managers and registered representatives in the ordinary course of business to be aware of, inquire about, and report to the AMLCO suspicious or unusual activity. Documents relating to their observations of or inquiries into suspicious activity or their failure to identify red flags should not be prohibited by the SAR privilege and should be produced when requested in discovery. It is the responsibility of the AMLCO to decide whether to file a SAR. Only discovery seeking documents relating to the SAR itself or discovery relating to the deliberative process of the AMLCO in deciding whether to file a SAR are prohibited by the privilege.

III. SUPPORTING CASES

According to nearly every court that has addressed the issue, the SAR privilege only protects from disclosure SARs themselves, documents that would reveal whether a SAR was or was not filed, and documents relating to the evaluation of whether to file a SAR. *In re JPMorgan Chase Bank, N.A.*, 799 F.3d 36, 44 (1st Cir. 2015); *Ackner v. PNC Bank, N.A.*, No. 16-cv-81648, 2017 WL 1383950, at *2-3 (S.D. Fla. Apr. 12, 2017) (Fraud detection policies and procedures are not protected by the SAR privilege since the privilege only covers SARs and documents showing that a SAR has been filed); *Pershing LLC v. Kiebach*, No. 14-2549, 2017 WL 1284146 (E.D. La. Apr.

6, 2017) (Internal incident reports relating to suspicious activity created in the ordinary course of business are not protected by the SAR privilege because they do not indicate whether a SAR was created); *Wultz v. Bank of China Ltd.*, 56 F.Supp.3d 598, 601-02 (S.D.N.Y. 2014) (Investigatory documents and written policies directing what steps employees should take when they identify suspicious or unusual activity are not protected by the SAR privilege); *First American Title Ins. Co., v. Westbury Bank*, No.12-CV-1210, 2014 WL 4267450, at *2-3 (E.D. Wis. Aug. 29, 2014) (To be protected from disclosure under the SAR privilege, upon review of the document, one "must be able to discern with effective certainty the existence of a SAR."); *In re Whitley*, No. 10-10426C-7G, 2011 WL 6202895, at *4 (Bankr. M.D.N.C. Dec. 13, 2011) (Documents relating to the investigation of suspicious activity that do not reveal the existence of a SAR are not protected by the SAR privilege); *Freedman & Gersten, LLP v. Bank of America*, No. 09-5351, 2010 WL 5139874, at *3 (D.N.J. Dec. 8, 2010) (Memoranda and documents drafted in response to suspicious activity (other than SARs or draft SARs), and policies and procedures relating to risk management and handling suspicious activity, are discoverable); *Gregory v. Bank One, Ind., N.A.*, 200 F.Supp.2d 1000, 1002 (S.D. Ind. 2002) (Only SARs and their contents are protected from disclosure, while supporting documentation and other reports of suspicious activity are not protected); *Weil v. Long Island Sav. Bank*, 195 F.Supp.2d 383, 389–90 (E.D.N.Y.2001) (Compelling the production of any "supporting documentation" that did not reveal the existence of a SAR or reveal its contents).

Incident reports and investigatory documents are not protected from disclosure by the SAR privilege unless they would specifically disclose whether a SAR has or has not been filed.

In *Pershing*, 2017 WL 1284146 at *2-3, the court held that summary reports prepared in the ordinary course of business as part of the process of internally investigating potential suspicious activity were not protected by the SAR privilege and that "detecting fraud is simply part of a financial institution's ordinary course of business." The court went on to explain, based upon the First Circuit's holding in *JPMorgan*, that the ultimately determinative inquiry is "whether any of [the] documents suggested, directly or indirectly, that a SAR was or was not filed." *Id.* at *3 (*quoting*, *JPMorgan*, 799 F.3d at 43-44). The court held that the summary reports were akin to incident reports and were not protected by the SAR privilege because, although they included an employee's thoughts and impressions about why activity appeared to be suspicious, they were "devoid of any information by which the reader can determine whether the matter identified therein progressed beyond the making of the report, much less whether an actual SAR was ever created. *Id.* at *3.

Similarly, the court in *Freedman*, 2010 WL 5139874 at *3, held that "documents and facts pertaining to the suspicious activity at issue in this matter, which were created in the ordinary course of business" are not protected by the SAR privilege. The court explained that "[a]lthough [the bank] may have undertaken an internal investigation in anticipation of filing a SAR, it is also a standard business practice for banks to investigate suspicious activity …." *Id.* As a result, the court ordered the production of any memoranda and documents created in response to the suspicious activity at issue, excluding only SARs and drafts of SARs. *Id.*

In *First American*, 2014 WL 4267450 at *1, the plaintiff sought documents related to certain "fraud alerts" related to the accounts at issue that the defendant bank may have received, including information automatically generated by the fraudulent transaction monitoring software. The court began by parsing the language of the federal regulation at issue, which only protects from disclosure "a SAR or any information that ***would*** reveal the existence of a SAR." *Id.* at *2 [emphasis added]. However, "information that, with the aid of supposition or speculation, might tend to suggest to a knowledgeable reviewer whether a SAR was filed, is not privileged." *Id.* at *3. The Court held that the use of the word "would" denotes that to be protected, one "must be able to discern with effective certainty the existence of a SAR" from the document. *Id.* at *2. The Court went on to hold that, "Simply because such facts may demonstrate that a bank was aware of a fraud that fit the requirements of a SAR, and a reasonable inference could be drawn that a bank will generally comply with federal regulations, this does not mean that such information 'would' reveal that the bank filed a SAR." *Id.* The Court went on to explain that "Not all means or methods a bank may use to detect fraud or other financial irregularity are privileged simply because they might culminate in a SAR", and "In most cases … the disclosure of supporting documentation would not reveal the filing of a SAR, and such documentation cannot be shielded from otherwise appropriate discovery simply because it has some connection to a SAR." *Id.* (citations omitted). Moreover, since "detecting fraud is part of a bank's ordinary course of business," documents generated a part of this standard business practice of investigating potential fraud or other irregularities are discoverable" and this "remains true even if this fraud investigation parallels the process of preparing a SAR."

In *Wultz*, 56 F.Supp.3d at 600, the plaintiff sought documents generated as a result of the bank's process of identifying and investigating suspicious or unusual activity, which process sometimes culminates in the information being presented to a bank committee charged with deciding whether to file a SAR. The bank gathered more than 10,000 documents generated as a result of this process, although it was unclear to the court whether or not any of the 10,000 pages included documents emanating from such committee. *Id.* The bank argued that all of the documents were protected by the SAR privilege since they result from the implementation of the bank's policies and procedures for the filing of SARs. *Id.* After conducting an *in camera* review of the documents, the court concluded that none of the documents indicated whether a SAR was filed, even though "a person with knowledge of SARs might deduce that certain banking activity would (or would not) result in the filing of a SAR." *Id.* The court went on to explain that nothing in the regulation barred production of documents prepared by a bank as part of its process to investigate suspicious activity. *Id.* at 601. Citing to various other cases, including *First American*, *Freedman*, *Whitley*, and *Weil*, the Court held that the investigatory documents sought were fully discoverable, and that the bank has not pointed to any "documents regenerated at the decision-making stage that contain a discussion of SAR requirements and reflect [the bank's] decision-making process specifically as to whether to file a SAR." *Wultz*, 56 F.Supp.3d at 602.

In *JPMorgan*, 799 F.3d at 37, the only Circuit Court to interpret the SAR privilege, victims of a Ponzi scheme brought claims against a bank, claiming that the bank failed to detect and stop the fraud. The First Circuit held that none of the documents were protected by the SAR privilege because they were only lists and descriptions of transactions, or, with regard to a small subset of the documents at issue, were not SARs or draft SARs, did not reflect the decision-making process as to whether a SAR should be filed, did not discuss the process of preparing a SAR, and did not

attempt to explain the content of a SAR post-filing. *Id.* at 44. The Court explained that "the key query is whether any of [the] documents suggest, directly or indirectly, that a SAR was or was not filed." *Id.* at 43. Thus, the Court rejected the bank's invitation to view the SAR privilege "as extending to any documents that might speak to the investigative methods of the financial institution." *Id.* at 44.

Lastly, in *Whitley*, 2011 WL 6202895 at *1, it was alleged that the debtor "was engaged in a Ponzi scheme whereby he defrauded investors from whom he obtained loans or investments by means of false representations that the funds would be invested in a manner that would result in high returns to investors." The debtor maintained a checking account at the subject bank. *Id.* The bankruptcy trustee sought documents relating to any investigation or inquiry by the bank of the debtor or his account, documents relating to any response to the investigation and the findings or observations, notes of the investigation, including references to any noted suspicious activity, and documents relating to any explanation the debtor may have given to the bank about his account activity. *Id.* at *2. The trustee also sought any suspicious activity reports made by the bank. *Id.* The Court analyzed the applicable federal regulation and case law and determined that although the SARs were protected by the SAR privilege, the other documents were discoverable because only SARs, documents that refer to a SAR having been filed, documents referring to information as being a part of a SAR, and documents revealing the preparation or filing of a SAR are protected. *Id.* at *3-4.

In accord are *Wiand v. Wells Fargo Bank, N.A.,* 891 F. Supp. 1214, 1217-1219 (M.D. Fla. 2013); *Rotstain v. Trustmark National Bank,* 2020 WL 1697990 (N.D. Texas 2020); *Erhart v. BOFI Holding, Inc.,* 2018 WL 5994417 (S.D. Cal. 2018); *Shapiro v. Wells Fargo Bank, N.A.,* 2018 WL 4208255 (S.D. Fla. 2018).

IV. THE FINANCIAL INDUSTRY'S POSITION

The principal argument advanced by the financial industry to resist discovery of its due course investigation of unusual or suspicious activity is that responsive documents are part and parcel of its evaluative process of making a decision whether to file a SAR. This argument is suggested by a 2010 FinCEN interpretation of the SAR privilege as barring the disclosure of "material prepared by the financial institution as part of its process to detect and report suspicious activity, regardless of whether a SAR ultimately was filed or not." 75 Fed. Reg. 75593, 75595 (December 3, 2010). The industry's suggestion that this should be taken to mean that the entire process of detecting or investigating suspicious activity in the ordinary course of business is an integral part of is evaluation of whether to file a SAR has not been accepted by the courts and is not derived from the regulatory language creating the SAR privilege.

In the recent case of *Federal Trade Commission v. Marcus,* 2020 WL 1482250 (S.D. Fla. 2020), a third-party bank argued that the receiver's request for AMLCO documents, with reference to whether a SAR was filed redacted, would disclose it processes and algorithms used to report suspicious activity, and, by implication, relate to the evaluative process of whether a SAR should be filed. The court denied the receiver's motion to compel, but, in doing so, reiterated the well-accepted proposition that the SAR privilege does prevent "disclosure of internal reports and

memoranda that merely concern observations of suspicious activity unrelated to the process of complying with federal reporting requirements." *Id.* at *6.

In *Marcus*, the bank made the often-raised argument that disclosure of its general AML process and procedures, even protected by a confidentiality agreement, may leak out and give bad actors intelligence that may assist them in avoiding detection. 2020 WL 1482250. While the court in *Marcus* did not address this argument, which neither arises under nor is supported by the regulation creating the SAR privilege, the argument was rejected by the courts in *Ackner v. PNC Bank*, 2017 WL 1383950*; Wultz v. Bank of China, Ltd*, 56 F.Supp.3d 598*;* and *Freedman & Gersten, LLP v. Bank of America*, 2010 WL 5139874.

V. CONCLUSION

The challenge in obtaining discovery of observations of potentially suspicious activity is in persuading arbitrators, who may reticent to make difficult decisions in the face of a claim of a federally mandated privilege, to wade through complex arguments unfamiliar to them. The analysis required will involve *in camera* review of documents and careful review of the law, which is largely based on district court opinions and one First Circuit decision. Relevant discovery, however, is critical to proof of a broker-dealer's liability in fraud, selling away and aiding and abetting cases.