June 2005

The Neutral Corner

WHAT'S INSIDE

Guidance for Arbitrators on Requests to Produce Suspicious Activity Report Information

By Judith R. Starr*

Since January 1, 2003, broker-dealers have been required to file suspicious activity reports (SARs) with the Department of Treasury's Financial Crimes Enforcement Network (FinCEN). These reports, mandated by the Bank Secrecy Act—a law that imposes reporting, recordkeeping, and anti-money laundering program requirements on financial institutions—are an important tool in the federal government's fight against financial crime and the financing of terrorism.[1] This article explains the privilege that applies to SARs, and provides guidance to arbitrators on dealing with requests to obtain such information from a broker-dealer.

Background on SARs

FinCEN administers the Bank Secrecy Act and, under its authority, has issued the rule requiring broker-dealers to report suspicious activity. FinCEN's SAR rule requires a broker-dealer to file a SAR if it "knows, suspects or has reason to suspect" that a transaction involving at least $5,000 conducted or attempted to be conducted through the broker-dealer: (1) involves funds from illegal activity; (2) is designed to evade reporting requirements; (3) has no business or apparent lawful purpose, or is not typical of the customer and the broker-dealer knows of no reasonable explanation for it; or (4) involves use of the broker-dealer to facilitate criminal activity.[2] SARs and other Bank Secrecy Act reports are

1 The Bank Secrecy Act is codified at 31 U.S.C. 5311-32. The SAR provisions are in section 5318(g).

2 FinCEN's broker-dealer SAR rule is codified at 31 CFR 103.19. To avoid duplicative filings, there is an exception to the reporting requirement for reports of securities violations that must be made by the firm itself or an associated person to the SEC or an SRO, such as the filing of a Form U-4 or U-5.

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Message from the Editor

In addition to comments, feedback, and questions regarding the material presented in this publication or other arbitration and mediation issues, *The Neutral Corner* invites readers to submit articles on important issues of law and procedure relating to mediation, arbitration, or other alternative dispute resolution processes. We, of course, reserve the right to determine which articles to publish.

Please send your article to Lisa Angelson, Editor, *The Neutral Corner* at NASD Dispute Resolution, One Liberty Plaza, 165 Broadway, 27th Floor, New York, New York 10006. You may also call the Editor at (212) 858-4392 for editorial guidelines.

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part of a government-wide data network maintained by FinCEN to support the investigation of financial crime and terrorism. FinCEN shares SAR information with other agencies for criminal, tax, regulatory, and counter-terrorism purposes.

Congress recognized that protection of the sensitive financial information in SARs—and the very act of a financial institution's filing a SAR—was necessary to encourage robust reporting of suspicious activity while protecting privacy interests and the confidentiality of law enforcement investigations. Therefore, the Bank Secrecy Act provides an unqualified privilege against compelled disclosure of SARs or of documents or testimony relating to their filing.[3] The statute prohibits any financial institution, and its officers, directors, employees, or agents, from notifying any person involved in a transaction that the transaction has been reported. FinCEN's broker-dealer SAR rule further provides that any person subpoenaed or otherwise requested to disclose a SAR or information contained in it (except where disclosure is requested by law enforcement or the firm's regulator) shall decline to produce a SAR or disclose any information that a SAR has been prepared and filed, and notify FinCEN of the demand.

3 *Whitney National Bank v. Karam*, 306 F. Supp.2d 678 (S.D. Tex. 2004).

To further encourage financial institutions to file SARs, Congress also provided them with a "safe harbor" from liability. The statute protects financial institutions and their agents from liability to any person under state, federal, or local law, or under a contract, including an arbitration agreement, as a result of filing a SAR or failing to disclose the filing of the SAR.

Although the broker-dealer SAR rule is too new to have generated reported decisions, the bank SAR rules issued by FinCEN and the federal banking regulators, which both contain substantially identical disclosure prohibitions, have existed since 1996, and have generated a number of decisions. The disclosure prohibitions of the statute and rules, combined with the safe harbor, led courts to conclude that Congress did not intend to permit them to order the disclosure of SARs.[4] In finding SARs to be absolutely privileged, courts also cited the harm from compelled disclosure, including tipping off criminals, revealing methods for detecting suspicious activity, and imperiling employees who make the reports.[5]

The protection from compelled disclosure extends beyond the SAR itself. Otherwise, compelled testimony from SAR preparers about the SAR, or production of documents disclosing a filer's communications with law enforcement about the SAR, could be used to subvert the disclosure bar. In a recent case, a litigant disclaimed interest in obtaining a SAR of which he allegedly was the subject, but sought communications between a bank and law enforcement about the matter. The court found that such communications fell within the scope of the privilege for SARs. Specifically, the court identified five types of communications protected by the privilege:

1) the SAR itself;
2) communications pertaining to the SAR or its contents;
3) communications preceding the filing of the SAR or preparatory to it;
4) communications that follow the filing of the SAR and are explanations or follow-up; and
5) communications concerning possible violations that did not result in a filing.[6]

It is important to note that the privilege does not extend to underlying transactional documents, such as account statements, transaction confirmations, and the like. Such ordinary business records are subject to the production standards of the particular proceeding. Nothing in the SAR rule or the Bank Secrecy Act protects such documents; rather it is the existence of the

4 *See Lee v. Bankers Trust Co.,* 166 F.3d 540 (2d Cir. 1999); *Weil v. Long Island Savings Bank*, 195 F. Supp.2d 383 (E.D.N.Y. 2001).

5 *See Cotton v. Privatebank and Trust Co.,* 235 F. Supp. 809 (N.D. Ill. 2002).

6 *Whitney v. Karam*, supra note 3.

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SAR and the matter contained within it, as well as related communications with law enforcement, that are protected.

Arbitrators and Requests for SARs

Arbitrators are likely to face requests for orders to produce SARs, or testimony or communications about them, in one of two fact patterns. An alleged subject of a SAR may be making a claim or asserting a counter-claim against a firm arising from the alleged filing; or the victim of unlawful activity that may be reflected in a SAR seeks to obtain any SAR filed on the activity to support the victim's case against the firm or an associated person. How should such requests be handled?

Broker-dealers and their agents are not permitted to reveal the existence of a SAR. Therefore, questions about reports to government agencies of suspected illegal activities should not be permitted. (Note that this prohibition does not extend to required filings with the SROs and the Securities and Exchange Commission (SEC), such as a Form U-4, which have a special exception from the SAR reporting requirement so as to avoid duplicative reporting.) The production of SARs should never be required, and documents generated through a firm's SAR review process, both pre- and post-filing (or documents relating to a decision not to file), should not be subject to a disclosure order. An arbitrator should not permit a party to elicit testimony concerning communications to law enforcement about suspected illegal activity. As noted above, the underlying business records, including account statements and transactional records, are not subject to the privilege. However, questioning about the activity reflected in such unprivileged documents should not be allowed to expand into questioning concerning the reporting of such activity.

Conclusion

One must protect the confidentiality of SARs in an arbitration. The production of a SAR or SAR information in an arbitration would harm a system that both Congress and the agency responsible for administering the authorizing statute have determined requires the existence of an unqualified privilege in order to achieve its aims.

** Judith R. Starr has been Chief Counsel of the FinCEN since December 2001, serving as its chief legal officer and supervising its legal staff. Before coming to FinCEN, she spent ten years at the SEC as Assistant Chief Litigation Counsel in the Division of Enforcement, and as an appellate attorney in the Office of General Counsel. She received the Stanley Sporkin Award for outstanding contributions to securities law enforcement in 1999, and was appointed to be a special prosecutor in the criminal contempt case against stock manipulator Robert Brennan by the United States District Court for the Southern District of New York. Ms. Starr was a commercial litigator in Los Angeles before joining the SEC. She is a graduate of Harvard Law School and the College of William and Mary.*

The views expressed herein are those of the author and do not necessarily represent the views of FinCEN or the Department of the Treasury.

Dispute Resolution 2005 Focus Groups

Each year, NASD Dispute Resolution (NASD DR) holds focus groups with a segment of our constituency to provide updates on changes in our forum and to solicit new ideas in an effort to find ways to improve the forum. There are five focus groups scheduled for 2005. The purpose of the event is to obtain feedback from the users of the forum. NASD DR staff provides attendees with an overview of the forum and discusses new developments. We also provide a description of the online claim filing process and NASD DR's efforts to reduce case turnaround time. Attendees are given an opportunity to inform us about their experiences as users of the forum and to provide suggestions for improvements.

To date, we have held focus groups in Wilmington, Delaware; Hartford, Connecticut; and Birmingham, Alabama. (More detailed descriptions of some of these focus groups are located in this issue's section titled, "Regional Updates.")

We will hold two additional focus groups during the remainder of 2005: Wichita, Kansas on September 7, 2005 (1 p.m. – 3 p.m.), and Boise, Idaho on November 15, 2005 (1 p.m. – 3 p.m.) with select NASD staff and senior management.

Dispute Resolution News

Case Filings

Arbitration case filings from January 1 through May 31, 2005 reflect a 28 percent decrease compared to cases filed during the same time in 2004. NASD DR experienced a decrease in case filings during this five-month period from 3,599 in 2004 to 2,594 in 2005. In a major effort to reduce the existing caseload, NASD DR increased by 10 percent the number of cases closed from January 1 through May 31, 2005 compared to the same period in 2004.

Latest in Arbitrator Training

NASD Dispute Resolution's Arbitrator Training Programs and Schedules

You can view the arbitrator training programs and schedules for all of 2005 on our Web site at: *www.nasd.com/arbitration_mediation.*

Arbitrator Tip

All members of NASD DR's roster of arbitrators are frequently reminded of their continuing obligation to update their Arbitrator Disclosure Report.

The reminder in this issue focuses on the need to update information that may affect an arbitrator's classification as either a public or a non-public arbitrator. As indicated in the February 2005 issue of this newsletter:

> *Arbitrator disclosure obligations include immediate notification of an arbitrator's change in employment, job functions, or clients since these facts can result in a change to the arbitrator's classification as a public or as a non-public arbitrator.*

Under the current rules, an arbitrator *may not* be classified as a public arbitrator:

- If the arbitrator is an attorney, accountant, or other professional who has devoted 20 percent or more of his or her professional work, in the last two years, to clients who are engaged in any of the securities industry; or
- If the arbitrator is an attorney, accountant, or other professional **whose firm** derived 10 percent or more of its annual revenue in the past two years from any persons or entities in the securities industry.

Keep in mind that if you are a mediator, Interpretive Material (IM) 10308 of NASD's *Code of Arbitration Procedure* clarifies that (1) fees for service as a mediator are not included in determining whether an attorney, accountant, or other professional derives 10 percent of his or her annual revenue from industry-related parties; and (2) service as a mediator is not included in determining whether an attorney, accountant, or other professional devotes 20 percent or more of his or her professional work to securities industry clients.

In today's ever-changing world, the percentage of an arbitrator's work, or the percentage of revenue derived by an arbitrator's firm, is subject to swings and shifts. When parties receive the arbitrator profiles, many of them will conduct research and even review the Web site created for an arbitrator's firm. If, for example, the firm's Web site emphasizes its work for clients in the securities industry, and the arbitrator is classified as an NASD public arbitrator, parties may inquire as to the accuracy of the arbitrator's classification. Therefore, it is incumbent on all arbitrators constantly to reevaluate their own and their firms' circumstances and to notify NASD DR immediately of any possible changes in their circumstances that might affect their classification on the forum's roster. Keep in mind that, in many instances, such disclosures may only result in an arbitrator's reclassification and may not subject him/her to removal from the roster.

Unsolicited Mass Emails to Arbitrators

We understand that an individual has been sending a series of unsolicited emails to many arbitrators on NASD's neutral roster. Several of you have asked about the origin of these emails, since the author purports to interpret and explain various NASD policies and the name "NASD Dispute Resolution" appears in the subject line. These emails have not been sent or authorized by NASD Dispute Resolution. We have been unable to determine with certainty how this individual obtained so many email addresses, since he has refused our request for that information.

We want you to know that NASD Dispute Resolution does not give out your email addresses to any person or organization. We did not release your email addresses to this email writer; nor is he authorized to represent the views or to interpret the policies of NASD or NASD Dispute Resolution. If you would like to stop receiving this individual's emails, please contact the sender directly.

NASD Dispute Resolution communicates with its arbitrators in many ways, including *The Neutral Corner*, postings on NASD's Web site, arbitrator in-person and Web-based training, telephone workshops, regular mail, and by emails that are clearly identified as being sent by NASD.

If you have any questions about NASD Dispute Resolution rules or practices, please feel free to contact any of the staff members listed in this newsletter and on NASD's Web site at *www.nasd.com/DR_staff*.

Regional Updates

Northeast Regional Update

On April 14, 2005, the Northeast Regional Office held a focus group in Hartford, Connecticut with various arbitrators and party representatives, attended by NASD staff and senior management. (For additional details about the focus group, please see our earlier article on page 5 of this issue.)

During the next three months, the Northeast Regional Office will conduct in-person Basic Panel Member Training programs in these cities on the following dates:

New York, New York	July 12, 2005
Buffalo, New York	August 9, 2005
New York, New York	August 17, 2005
Augusta, Maine	September 22, 2005
Boston, Massachusetts	September 23, 2005

If you are interested in attending a Basic Panel Member Training program, please contact Cheree White at (212) 858-4063 or by email at Cheree.White@nasd.com.

Mid-Atlantic Regional Update

On March 30, 2005, the Mid-Atlantic Regional Office held a focus group in Wilmington, Delaware with various arbitrators and party representatives, attended by NASD staff and senior management. (For additional details about the focus group, please see our earlier article on page 5 of this issue.)

During the next three months, the Mid-Atlantic Regional Office will conduct in-person Basic Panel Member Training programs in these cities on the following dates:

Pittsburgh, Pennsylvania	August 18, 2005
Philadelphia, Pennsylvania	September 8, 2005

If you are interested in attending a Basic Panel Member Training program, please contact Karen Carter at (202) 728-8327 or by email at Karen.Carter@nasd.com.

Western Regional Update

The Western Regional Office recruited arbitrators at the Annual ABA Dispute Resolution Conference in Los Angeles, California held April 14 – 16, 2005, and at the Nevada State Bar Annual Meeting in Santa Fe, New Mexico held June 22 – 25, 2005. The Western Regional Office plans to recruit arbitrators at the following upcoming conference:

The Iowa State Securities Conference
Sun Valley, Utah July 13 – 16, 2005

During the next three months, the Western Regional Office will conduct in-person Basic Panel Member Training programs in these cities on the following dates:

Los Angeles, California	July 12, 2005
San Diego, California	August 16, 2005
Portland, Oregon	September 13, 2005

If you are interested in attending a Basic Panel Member Training program, please contact Tiffany Hansmann by telephone at (213) 613-2684 or by email at Tiffany.Hansmann@nasd.com.

Midwest Regional Update

The Midwest Regional Office is pleased to announce the opening of new hearing locations in Rapid City, South Dakota and Bismarck, North Dakota. If someone you know is interested in serving as an arbitrator or mediator in either Rapid City or Bismarck, please contact our Recruitment Supervisor, Neil McCoy, at (212) 858-4283.

During the next three months, the Midwest Regional Office will conduct in-person Basic Panel Member Training programs in these cities on the following dates:

Minneapolis, Minnesota	July 13, 2005
Houston, Texas	August 17, 2005

If you are interested in attending a Basic Panel Member Training program, please contact Deborah Woods at (312) 899-4431 or by email at Deborah.Woods@nasd.com.

Southeast Regional Update

On May 3, 2005, the Southeast Regional Office held a focus group in Birmingham, Alabama with various arbitrators and party representatives, attended by NASD staff and senior management. (For additional details about the focus group, please see our earlier article in this issue.)

During the next three months, the Southeast Regional Office will conduct in-person Basic Panel Member Training programs in these cities on the following dates:

Boca Raton, Florida	September 7, 2005
Memphis, Tennessee	September 29, 2005

If you are interested in attending a Basic Panel Member Training program, please contact Lanette Cajigas at (561) 447-4911 or by email at Lanette.Cajigas@nasd.com.

Question and Answer: Arbitrator Service in Multiple Hearing Locations

Question: I read that NASD Dispute Resolution (NASD DR) opened hearing locations in all 50 states. What are the travel reimbursement guidelines? Also, if I reside between two different hearing locations, can I serve in both arbitrator pools?

Answer: NASD DR's policy regarding arbitrators serving in multiple hearing locations is listed in the Guidelines for Reimbursement, which is located on our Web site at *www.nasd.com/arbitration_mediation*. There are three different situations that might pertain:

1. arbitrators who live or work within 120 miles of their primary hearing locations will be reimbursed for mileage, parking, and lunch within the parameters specified in the guidelines;

2. arbitrators who live more than 120 miles from their primary hearing location will be reimbursed for reasonable reimbursable travel expenses when serving in their primary hearing location, such as lodging, meals, air travel, and/or ground transportation; and

3. arbitrators who elect to serve in additional hearing locations outside of their primary hearing location are not entitled to reimbursement of any travel expenses with the exception of lunch.

Arbitrators are reminded that they *must* obtain written authorization from the appropriate NASD DR Regional Director before incurring travel expenses. Failure to obtain prior written authorization will result in NASD DR's refusal to reimburse such travel expenses.

Arbitrators may apply for service in more than one hearing location, but the appropriate Regional Director maintains the discretion to approve these requests, taking into consideration the need for arbitrators in that location, as well as the current caseload.

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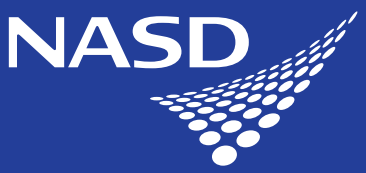

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