OPINION

THE SARS REGIME

Is it fit for purpose?

Gary Pons of 5 St Andrew's Hill examines whether the regime of filing suspicious activity reports is an effective tool in the fight against financial crime and money laundering.

GARY PONS

Documents obtained from the US Treasury Department's Financial Crimes Enforcement Network (FinCEN) have encouraged public attention to focus on suspicious activity reports (SARs), providing the public with stark evidence of the prevalence and scale of financial crime and money laundering within banks and financial institutions. The leak of the so-called FinCEN papers has prompted questions about the SARs regime, in particular: why are the measures designed to ensure that financial institutions co-operate with law enforcement authorities to prevent money laundering not working; and what do the FinCEN papers tell us about the failings of the SARs regime?

The FinCEN papers

The FinCEN papers, like the Panama papers before them, are confidential documents provided to the media (*see News brief "Panama papers: time to firm up on cyber security?", www.practicallaw.com/8-627-0529*). Buzzfeed, the US media website, obtained over 2,100 SARs from FinCEN. These SARs originate from banks and financial institutions, and were sent to FinCEN to provide the details of transactions that were suspected to involve money laundering.

SARs are provided to FinCEN on a confidential basis, so they are not publicly available. There can be little doubt that they indicate the failure of the SARs regime in the US. However, they also raise concerns about the way that the SARs regime operates in the UK; for example, whether banks are relying on a lack of knowledge of the precise derivation of the funds and whether SARs protect the financial institution rather than providing law enforcement authorities with vital intelligence (*see box "SARs regime in the US"*).

Purpose of SARs

SARs require entities in the regulated sector, often banks and financial institutions, to notify law enforcement authorities that certain client activity is suspicious and might indicate money laundering or terrorist financing. The statutory provisions are set out in sections 330 to 339 of the Proceeds of Crime Act 2002 (POCA), compelling banks and financial institutions to make a SAR where certain conditions are met. In the modern world, these financial institutions control the movement of money and possess the kind of information that law enforcement authorities require to tackle money laundering. That is the benefit of SARs: they allow crucial information about potential money laundering to be provided by the financial institutions to law enforcement.

There are two different types of SARs:

- An authorised disclosure. Where a bank or financial institution suspects that they are being asked to deal with the proceeds of crime, they can disclose their suspicion to the UK Financial Intelligence Unit (UKFIU), the UK equivalent of FinCEN, and request consent to complete the transaction. The benefit to the financial institution of an authorised disclosure is that where consent has either been granted or, if it has been refused, the mortarium period has expired, it provides a defence to a potential charge of money laundering that the relevant individual in the financial institution could face.

- A required disclosure. Banks and financial institutions are compelled by law to make a disclosure if they have reasonable grounds for suspecting that a person is engaged in money laundering. It is necessary that the grounds for suspicion have come to the person making the report in the course of their business.

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SARs regime in the US

In a press release published on 29 September 2020, Linda Lacewell, the superintendent of the New York State Department of Financial Services, said that:

"Insiders have known for decades that the financial system is awash with trillions of dollars in dirty money running through the system.

Banks say they did not actually know the money was criminally derived, yet they have been permitting massive transactions to run through shell companies to money laundering havens, with no apparent business purpose, notifying the Financial Crimes Enforcement Network and taking their cut in fees.

The suspicious activity report — originally intended to alert law enforcement to potentially criminal activity — has become a free pass for banks. The report itself is frequently riddled with the names of anonymous shell companies that make it practically impossible to determine the identity of the perpetrators." (*www.dfs.ny.gov/reports_and_publications/press_releases/pr202009291*).

This makes the point in a rather stark way. Anti-money laundering provisions are not working; banks are permitting money laundering to occur. While this is a commentary based on the US system, given the global nature of banking, it raises concerns about the way that the SARs regime operates in the UK.

In requiring financial institutions to be proactive in combating money laundering, the SARs regime should result in the provision of quality information to law enforcement. SARs are obviously an important tool in the fight against organised crime and money laundering. The real question is whether they work; for example, whether the nature of the information provided is of sufficient use that law enforcement authorities are able to react to them and whether law enforcement authorities have the ability to react to them.

Do SARs work?

The Law Commission's 2019 report on the SARs regime (the report) commented that high-quality SARs, which are rich in data and submitted in an easily digestible format, can provide important evidence of money laundering in action (*see Briefing "Criminal Finance Act 2017: crime still doesn't pay", www.practicallaw.com/w-022-9657*). SARs can work and it is easy to forget that, in many cases, they do work. Nevertheless, the FinCEN papers make clear that there is a real problem with the way in which the SARs regime operates; in particular, that too many SARs are being submitted.

Last year in the US, banks and other financial institutions filed more than 2 million SARs. In the UK, over 450,000 SARs were received and processed by the UKFIU between April 2017 and March 2018. Such large numbers of SARs require significant resources, which are simply not available, to conduct a proper analysis. The large number of SARs seems to suggest that the SARs regime is working. The reality is that this is only correct if the SARs are easy to understand and properly made. Regrettably, that is often not the case.

The difficulty is that there is a fundamental tension between the purpose of the reporter of the SAR and the law enforcement agency receiving it. This tension was highlighted by the Law Commission in its report: "The focus of SARs from the reporters' point of view is frequently to provide protection against a potential allegation of money laundering, rather than on providing quality information designed to prevent money laundering. This has led to a large quantity of SARs when what is desired by law enforcement is high quality SARs."

The Law Commission highlighted the following additional problems with the current regime:

- The current provisions are complex, with no definitive guidance. This means that reporters face a challenge to correctly understand and apply the law.
- Reporters often fail to apply the correct test.
- Reporting and assessing SARs is a resource-intensive process, both for the UKFIU and the financial institutions.

The Law Commission made a number of recommendations, including:

- Conducting more regular analysis into the nature and quality of SARs.
- Producing statutory guidance on the concepts that define when a SAR should be made.
- Establishing an advisory board with oversight for the regime and a role in advising the government on how it can be improved.
- Submitting SARs in a uniform online form.
- Extending the circumstances in which a reporter may have a reasonable excuse for not making an authorised disclosure.
- Carrying out further research into thematic reporting; that is, where a reporter has no discretion to assess suspicion but instead must make a report if certain criteria are met, such as when certain transactions exceed a prescribed value. In the Netherlands, for example, money transaction offices have a duty to report all transactions exceeding €2,000.

The report recognises that the current approach is not working. It results in too

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many SARs, which are frequently of poor quality. The next stage is for the government to review the report and its recommendations and make an interim report.

Money laundering regulations

The Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017 (*SI 2017/692*) set out the additional obligations of private sector firms working in areas of higher money laundering risk (*see Briefing "New anti-money laundering regulations: a risk-based approach", www.practicallaw.com/w-009-3383*). This includes banks and financial institutions. These organisations are required to: have measures in place to identify their clients; monitor how the clients use their services; and establish certain procedures to enable them to identify and report suspected money laundering and terrorist financing.

The Money Laundering and Terrorist Financing (Amendment) Regulations 2019 (*SI 2019/1511*) (2019 Regulations) came into force on 10 January 2020, implementing the Fifth Anti-Money Laundering Directive (*2018/843/EU*) (MLD5) (*see Briefing "Money laundering: EU responds to terrorist financing and the Panama papers affair", www.practicallaw.com/w-015-8858*). They amend Schedule 9 to POCA to expand the definition of businesses in the regulated sector to cover:

- Tax advisers.
- Letting agents.
- Art market participants.
- Cryptoasset exchange providers.

This increases the number of institutions that are required to comply with the current SARs regime. The logic for the inclusion of these businesses is hard to criticise as they all operate in sectors where the risk of money laundering is high. The inevitable consequence of this, however, is that there will be more SARs, many of which will be of poor quality. Expansion of the SARs regime does not address the problems within it.

The 2019 Regulations also introduced a mechanism that allows law enforcement authorities to make direct requests for information from a credit institution, including the account number, the name of an account holder and their personal details, such as date of birth and address. This is encouraging but will only assist where law enforcement authorities have enough information to realise that they should be asking questions. It is not a substitute for the efficient and effective functioning of the SARs regime.

The UK was required to make the 2019 Regulations in order to implement MLD5 given that the effect of the UK-EU withdrawal agreement is that EU law continues to apply during the transition period. The UK's ongoing relationship with the EU remains undecided. In the future, the UK will decide its own direction in respect of anti-money laundering provisions. It is likely that the UK will continue to comply with the requirements set by the Financial Action Task Force, the global money laundering and terrorist financing watchdog. The current focus on the SARs regime highlights that, to be effective in the fight against money laundering, the regime needs reform urgently.

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