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Swiss Financial Market Supervisory Authority FINMA

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FINMA position paper on legal and reputational risks in cross-border financial services

("Position paper on legal risks")

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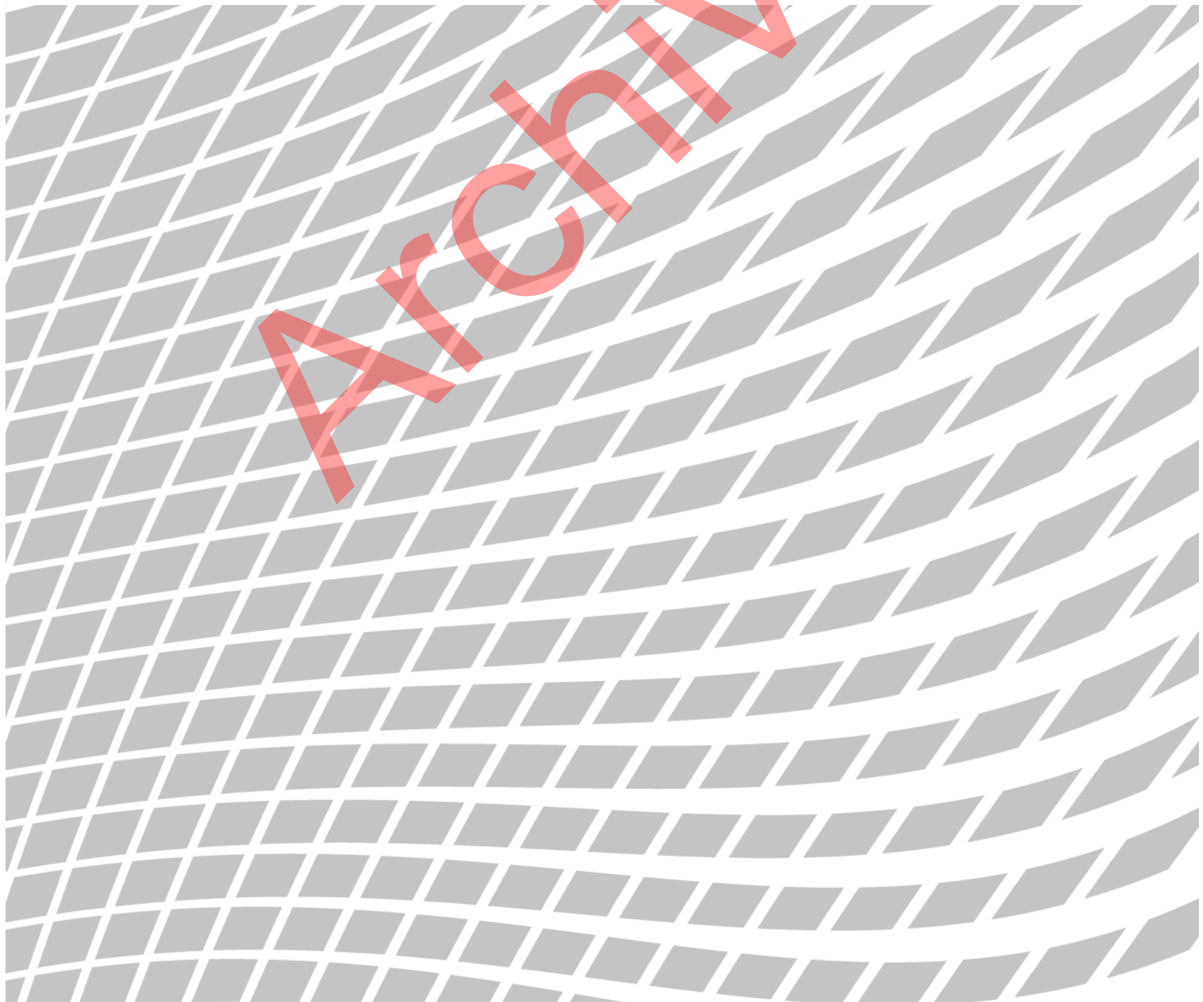

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Key issues

Context and recent developments

The business models of many wealth management banks are strongly focused on cross-border services for private clients resident outside Switzerland. Insurers have also transacted more business with cross-border elements in recent years.

The legal and reputational risks associated with cross-border financial services have increased markedly in recent years, to the extent that they have threatened the continued existence of some institutions and have had a destabilising effect on the economy. These risks do not just concern banks and insurers, but also other financial services providers involved in cross-border activity.

Legal and reputational risks under foreign law

There are two main types of risk arising under supervisory jurisdictions outside Switzerland: risks associated with the cross-border provision of *financial services*, and those associated with the cross-border supply of *financial products.* Both are subject to restrictive requirements in many legal systems (e.g. physical presence, registration). From a tax and criminal law perspective, there is the risk of financial intermediaries or their employees becoming *party to tax offences* under foreign law committed by foreign clients (e.g. as an aider or abettor). In addition, frequent cross-border activity and the regular physical presence of institution representatives in specific countries could in themselves give rise to *tax liability on the part of financial intermediaries*. Further legal and reputational risks could arise under foreign anti-money laundering legislation and civil law, conflict of law rules and procedural rules. There may also be risks linked to other areas of commercial law in certain countries.

Swiss supervisory approach to breaches of foreign rules

The Swiss Financial Market Supervision Act (FINMASA) does not contain any direct, explicit provisions requiring regulated institutions to comply with foreign law. However, the Insurance Supervision Act (ISA) imposes certain obligations on insurers in respect of business transacted outside Switzerland. Although supervisory legislation as such does not contain provisions equivalent to the ISA, breaches of foreign rules may have implications under Swiss law in certain circumstances.

For example, breaches of foreign legislation may violate certain Swiss supervisory rules – formulated in general terms – such as the requirement to assure that business is conducted in a proper manner. Supervisory rules regarding organisational structure primarily require institutions to identify, mitigate and monitor all risks, including legal and reputational risks, and to establish an effective system of internal control. Financial services groups and conglomerates are also obliged to operate a group-wide, appropriate risk management system and put in place an appropriate organisational structure. All these requirements also apply to cross-border business. In a number of cases in the past, FINMA and the organisations that preceded it instigated proceedings against institutions under their

Archive

supervision and penalised them for shortcomings in their treatment of risks under foreign law.

Expectations of supervised institutions engaging in cross-border financial services

FINMA believes it is essential, in view of developments in recent years, for supervised institutions to conduct a thorough *assessment* of the legal framework and the risks associated with their current cross-border business. Subsequently, suitable measures to mitigate or eliminate risk are to be taken. In its capacity as supervisor, FINMA expects institutions to duly observe foreign supervisory legislation in particular, and to define a service model appropriate for each individual target market.

FINMA does not regard the outsourcing of the management of client relationships to external asset managers as an effective means of mitigating or eliminating risk. It expects the supervised institutions to which this applies to also take due account of the risks potentially generated by external asset managers, intermediaries and other service providers. Due care must therefore be exercised in selecting and instructing such partners.

When transacting business involving insurance wrappers, banks, securities dealers and asset managers must conduct their dealings with providers of these products so as to ensure that the requirements defined in FINMA Newsletter 9 (2010) are properly implemented. In an updated newsletter that will abrogate FINMA Newsletter 9 (2010), the supervisory authority will clearly communicate the obligations of the financial intermediaries affected. Under all circumstances, insurers with business models involving insurance wrappers have an ongoing supervisory responsibility to discharge their identification obligations.

Supervised institutions are responsible for developing the requisite country-specific and other expertise in-house or procuring it. FINMA welcomes the dissemination of country-specific information through the Swiss Bankers Association and encourages any such initiatives by the industry.

FINMA expects to be informed immediately if any supervised institution is affected by significant legal and reputational risks in connection with cross-border financial services, or is contacted by any foreign authorities regarding such matters.

As part of its ongoing supervision, FINMA will increasingly focus in future on the conduct of institutions engaging in cross-border operations. FINMA will also ensure that due account is taken of the distinctive features of the various categories of supervised institutions. FINMA will cooperate with institutions in implementing the *assessment process* and *related measures* and systematically monitor implementation by some institutions. The position presented in this paper will also be reflected in FINMA’s future enforcement policy.

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Contents

1 The significance of cross-border financial services business 5

2 Growing legal and reputational risks associated with cross-border financial services business 6

2.1 Introduction 6

2.2 Supervisory legislation 6

2.3 Tax and criminal law 8

2.4 Anti-money laundering legislation 8

2.5 Civil law, conflict of laws, procedural law 9

2.6 Other commercial law 10

3 Assessment of foreign legal risks under Swiss law 11

3.1 Supervisory legislation 11

3.2 Criminal law 13

4 FINMA's expectations 14

4.1 Introduction 14

4.2 Conducting thorough assessments 14

4.3 Measures to mitigate and eliminate risk 15

4.4 Accumulating the necessary expertise 17

4.5 Notification of any problems with foreign authorities 17

4.6 FINMA will address risk management as part of its ongoing monitoring activities . 18

Archive

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1 The significance of cross-border financial services business

The financial services sector is a major contributor to the Swiss economy. The business models of many wealth management banks are strongly focused on cross-border services for private clients resident outside Switzerland. Some insurers have also increasingly transacted business with cross-border elements in recent years. The challenges surrounding these business models do not just impact on individual financial institutions, but also the economy as a whole.

The legal and reputational risks associated with *cross-border financial services* have increased markedly in recent years, to the extent that they could threaten the continued existence of some institutions and have a destabilising effect on the economy. These risks do not just concern banks and insurers, but also other financial services providers involved in cross-border activity.

This position paper outlines these legal and reputational risks as identified and analysed by FINMA, and provides clear guidance on how FINMA expects supervised institutions to deal with such risks.

Further observations: subject matter of this position paper

This position paper addresses the legal and reputational risks in financial services arising from breaches or circumventions of the rules and regulations in foreign jurisdictions which apply in a given set of circumstances (e.g. the supply of services or sale of products).

This position paper is intended for banks, insurance companies, securities dealers and licence holders subject to prudential supervision under the Collective Investment Schemes Act which are supervised by FINMA and engage in cross-border financial services business.

The term “cross-border financial services business” extends to all activities, services or product ranges offered by banks, insurance companies, securities dealers and licence holders subject to prudential supervision under the Collective Investment Schemes Act to *clients resident in a third country* (“foreign clients”). Private client business is its central facet. However, it should be noted that significant legal and reputational risks may also arise from providing cross-border services to institutional clients, or carrying out other activities with a foreign dimension (e.g. processing payment transactions).

The term “cross-border” thus encompasses both traditional *offshore* business transacted by Swiss-based institutions with foreign clients and scenarios involving the provision of services to foreign clients by foreign-based subsidiaries, branch offices, etc. of Swiss financial institutions.

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2 Growing legal and reputational risks associated with cross-border financial services business

2.1 Introduction

The legal and reputational risks associated with cross-border financial services have increased significantly over recent years. This has less to do with tighter foreign supervision than with the systematic enforcement of such rules. Investigative methods have been expanded, as exemplified by incidents of telephone tapping or purchases of stolen data. These latter incidents also illustrate the growing challenge facing Swiss institutions in striving to balance the confidentiality standards applying in Switzerland with operating in a highly digitalised and globalised environment. Numerous submissions of voluntary self-disclosure prompted by tax amnesty have had a further knock-on effect, with clients attempting to exculpate themselves by disclosing information about their bank or client advisor. Other factors may come into play, for example due to the specific organisational structure of institutions and groups (e.g. simultaneous onshore presence) and other circumstances (e.g. contracts with foreign government agencies).

The information below is intended to provide an overview of potential sources of legal and reputational risks in relation to cross-border financial services business.

2.2 Supervisory legislation

There are two main types of risk arising under supervisory jurisdictions outside Switzerland: risks associated with the cross-border provision of *financial services*, and those associated with the cross-border supply of *financial products*.

Cross-border *banking, securities, insurance and other financial services* are frequently regulated activities outside Switzerland. Depending on the country and type of service, the supply of services may be subject to restrictions or unlawful without authorisation by the local supervisor. While in Switzerland supervision of such activities is generally non-prescriptive, even simple activities are restricted or banned in some countries. Assessments as to whether such services are lawful may also vary, depending on how and where the client actually received the service (e.g. on-site client visit, client visit by a local representative, by remote means, or in the branch office of the Swiss service provider).

Examples: regulated activities outside Switzerland

Client acquisition and provision of client services through intermediaries abroad

A bank engages in offshore operations involving clients in neighbouring countries. With a view to expanding and cultivating its client base, it cooperates with a sizeable network of external intermediaries based in the clients' countries of residence. Pursuant to appropriate authorisations, these intermediaries also act as asset managers, make investment decisions on behalf of clients and

Archive

issue orders to the bank. The issue to be addressed here is not just whether the intermediary requires a local licence, but also whether the bank needs to obtain an authorisation or licence from the local supervisor due to the sales operations directed at the relevant target market.

Regulated banking activities outside Switzerland

- Socialising: meetings held in the client's home country solely for customer care and social purposes are permitted in most countries.
- Cold calling: unsolicited calls to potential clients are banned in many countries (e.g. Germany, the UK).
- Securities services: in many jurisdictions it is unlawful to offer securities safekeeping and custody services to clients without an authorisation or licence (e.g. Spain, France).
- Promotional and marketing activities: promotions of banking or investment products targeted at residents of specific countries are banned in most countries, or are unlawful without an authorisation or licence (e.g. Brazil, USA).

Regulated insurance activities outside Switzerland

The system of insurance supervision in many countries *requires companies to obtain a licence* in order to operate within their territory (e.g. Germany, France, Italy, UK, USA). Only in very rare cases are companies permitted to offer or provide services across borders without maintaining a physical presence in the country and without a licence. In some countries, insurance policies taken out in breach of local supervisory rules will either be voidable or void (e.g. Italy, France).

Financial products offered and sold within a particular market are also regulated in many cases and, depending on the target country and product category, must be authorised or registered with local supervisory bodies. In addition, companies offering financial products to the public in the local market are often required to produce a prospectus under foreign supervisory rules.

Example: regulated insurance products

Insurance companies selling products incorporating collective investment schemes to U.S. investors are required to verify whether the funds have to be registered with the U.S. Securities and Exchange Commission (SEC). Insurance companies must check funds on a case-by-case basis, because not all funds need to be approved by the SEC. In particular, there are a number of life insurance products that must be authorised. In addition to carrying out these controls, insurance companies must also comply with existing disclosure requirements. Prospectuses for securities offered must clearly disclose any applicable warnings and risks for U.S. clients.

The effect of such rules is to impede access to foreign markets. Any breaches of the rules also give rise to significant legal and reputational risks for the institutions concerned and possibly also their employees. Institutions that also offer onshore services in the same market, or have other relevant dealings in that country, are particularly vulnerable. Failure to comply with foreign supervisory rules

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may also result in administrative sanctions. Moreover, such activities may be prosecutable offences and give rise to civil liability on the part of institutions (e.g. right to cancel transactions).

2.3 Tax and criminal law

From a tax and criminal law perspective, there is the risk of financial intermediaries or their employees becoming party to tax offences under foreign law committed by foreign clients (e.g. as an aider or abettor). What constitutes assisting in the commission of an offence will be determined by applicable foreign law. In some jurisdictions, criminal offences can even include acts performed exclusively or largely outside the country, e.g. on Swiss territory. Careful consideration must therefore be given to the range of services offered to foreign clients, and in particular the policy governing client visits, and appropriate guidelines must be laid down. Some former employees of Swiss banks involved in cross-border transactions with U.S. clients and advisors to U.S. clients have been charged, among other things, with aiding and abetting in the commission of tax offences.

Example: realisation of tax and criminal risks

A Swiss bank with U.S. branches is being investigated by various U.S. authorities. The bank has been accused of breaching provisions of U.S. securities law and tax law, as well as undertakings under the Qualified Intermediary Agreement (QIA), in transacting cross-border business with U.S. private clients. In the course of the investigations, there have been increasing signs that individual client advisors had been helping high net worth U.S. clients to avoid disclosure and tax requirements arising from the QIA. It appears that at the time of the introduction of the QI regime, these advisors created offshore structures for the clients in question where they could hold U.S. and non-U.S. securities. There is also evidence of breaches of U.S. securities law in connection with the supply of cross-border services to U.S. clients.

The U.S. Department of Justice (DoJ) finally brought charges against the bank which potentially posed a threat to its continued existence. The bank subsequently negotiated a very costly settlement with the DoJ and U.S. Securities and Exchange Commission (SEC). This settlement does not include the U.S. Internal Revenue Service, which mainly targets clients who may be evading tax and taking action against the bank for recovery of unpaid taxes. This has produced a jurisdictional conflict between Swiss and U.S. laws.

In addition, frequent cross-border activity and the regular physical presence of bank representatives in specific countries could in themselves give rise to a corporate tax liability on the part of the financial intermediary. The consequences of being judged to effectively be a branch may also include being required to disclose information about clients in accordance with local law and being subject to local reporting and withholding tax regulations, which harbours potential for legal conflicts.

2.4 Anti-money laundering legislation

There may be legal and reputational risks to institutions providing cross-border services arising from anti-money laundering legislation. For example, there may be a duty under applicable local law to

Archive

report suspicious activity to the relevant local agencies when there is reason to believe that a client has perpetrated tax fraud or other offences. This may lead to a conflict of interests in cases where, by reporting the activity, institutions would themselves potentially become subject to the charge of aiding and abetting an offence.

2.5 Civil law, conflict of laws, procedural law

Financial services providers engaging in cross-border operations may be held *civilly liable* under foreign law. For example, supervisory breaches may give rise to civil liability, with the implication that clients have the right to contest contracts with the provider, or that contracts are void.

Examples: civil liability risks

- In February 2010, the Court of Justice in Vaduz held (at first instance) that a Liechtenstein bank was required to compensate a German client in respect of a pecuniary sanction connected with a condition of probation he was ordered to pay by a German court. The Court held that the bank had been too late in informing the client of the theft of his data, preventing him from making voluntarily self-disclosure to the German authorities at the appropriate time. However, the court held that the bank was not liable for the back taxes and fine payable by the client. According to established Swiss case law, orders for back taxes or fines made on the basis of fault are not recoverable losses under civil law, as they are strictly personal to the individual concerned. The position is quite different in relation to causative breaches of contractual disclosure obligations (cf. BGE 134 III 59).
- A U.S. client carries out a securities transaction through his Swiss bank in breach of the provisions of the U.S. Securities Exchange Act (1934). Violations of the broker-dealer registration requirements under the Act give clients a right of revocation. The client incurs a large loss on his investment in the course of the financial crisis and asserts his right to revoke the transaction. The bank has to reverse the transaction and compensate the loss incurred in the meantime.
- An inexperienced foreign client follows the advice of his client advisor at a Swiss bank and invests in a hedge fund. The investment has negative tax effects for the client in his home country; in addition, he suffers a massive loss as a result of the financial crisis. In a civil suit brought against the bank, one of the arguments used by the client's lawyer is that this product was not suited for the client for various reasons; firstly, the product is not at all attractive for clients from the country in question because of the tax implications and should not even have been offered to them, secondly the investment was not compatible with the client's risk profile.
- A U.S. client is convicted of tax evasion and ordered to pay a fine. He takes civil action in the U.S. against his Swiss bank, former client advisor and the bank's senior management for recovery of back taxes and fines, claiming that the defendants induced him to evade tax.

In addition, financial services providers engaging in cross-border business may come up against conflict of laws and procedural issues in relation to consumer or investor protection. This could arise, for example, in litigation between a client and financial intermediary, where a foreign court does not recognise the choice of jurisdiction and choice of law clauses in the terms and conditions of business, applying the *lex fori* instead. Furthermore, engaging in (unconsidered) prorogation or accepting the

Archive

jurisdiction of foreign courts (e.g. in the U.S.) can create a disadvantageous position from which to conduct proceedings.

Further observations: charges in client's place of residence applying *lex fori*

The revised Lugano Convention (LC) on jurisdiction and the enforcement of judgments in civil and commercial matters is due to take effect on 1 January 2011. The LC determines the international jurisdiction of the courts of signatory states. It also ensures that judgments from one signatory state are recognised and enforced in the other signatory states. The most important innovation relating to the revised LC is the extension of its territorial scope to the new EU member states. The revised Convention will also have a bearing on courts' powers to review contracts between financial institutions and clients from LC member states. This will enable clients to take legal action in their home country where the bank has "directed" its services to that country or member state. The precise definition of the term "direct" still needs to be elucidated by case law.

Since 17 December 2009, the Rome I Regulation (No. 593/2008 of the European Parliament and of the Council of 17 June 2008) governing contractual obligations in civil and commercial matters has applied to EU member states, superseding the international private law legislation enacted by those member states. The Regulation determines the law applicable to contractual obligations. The parties can essentially select the law applicable to contractual obligations, although in the case of consumer and insurance contracts, the parties are afforded limited autonomy in the interests of protecting the "weaker party". Where the services provided by the financial intermediary are "directed" to the client's country of residence or member state, mandatory consumer protection rules may prevail over any choice of law made.

As a result, banks in all LC member states can expect increasing numbers of lawsuits subject to mandatory local law in their clients' countries of habitual residence.

A Swiss judge could also conceivably rule that mandatory foreign rules take precedence over Swiss provisions by virtue of Art. 19 of the Swiss Federal International Private Law Act (IPRG; SR 291).

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2.6 Other commercial law

In some jurisdictions, worldwide application is claimed for local rules relating to citizens or the national currency. For example, there may be bans or restrictions on banks executing USD transactions for individuals or authorities from other countries under sanctions. Significant legal and reputational risks may arise in connection with the enforcement of such rules either directly or indirectly against foreign institutions and their employees who are in breach of the rules. Due account should therefore be taken of such universal approaches and precepts.

Example: USD payment transactions by Swiss banks

A Swiss bank with U.S. branches carries out USD payments on behalf of countries and parties subject to U.S. sanctions, and is forced to reach a costly settlement with the U.S. authorities in order to bring the proceedings against it to a close.

3 Assessment of foreign legal risks under Swiss law

3.1 Supervisory legislation

The Federal Act of 22 June 2007 on the Swiss Financial Market Supervisory Authority (Swiss Financial Market Supervision Act, FINMASA; SR 956.1) does not contain any direct and explicit wording requiring regulated institutions to comply with foreign law. However, the Insurance Supervision Act provides that the granting of a licence by FINMA to conduct insurance business requires any applicant intending to operate outside Switzerland to supply its services to target markets in compliance with foreign supervisory legislation (cf. Art. 4 para. 2 let. c; Art. 5 para. 2 Insurance Supervision Act, ISA; SR 961.01). Appropriate licences from foreign supervisors or clearance declarations must be obtained for this purpose. Any subsequent changes to foreign operations affecting the business plan must also be notified to FINMA.

Even where the other supervisory legislation does not contain provisions equivalent to the ISA, breaches of foreign rules may have implications under Swiss law in certain circumstances. For example, breaches of foreign legislation may also violate certain Swiss supervisory rules – formulated in general terms – such as the requirement to assure that business is conducted in a proper manner. Above all, under the supervisory rules regarding organisational structure, institutions are required to identify, mitigate and monitor all risks, including legal and reputational risks, and put in place an effective system of internal control. The same requirements apply to financial services groups and conglomerates.

Archive

Further observations: Rules applying to banks, securities dealers and collective investment schemes

One of the licensing requirements that must be complied with on an ongoing basis is that banks must have an administrative organization commensurate with their business activities and assure the proper conduct of their business activities at all times (cf. Art. 3 para. 2 let. a and c of the Banking Act, BA, SR 952.0). Banks must lay down rules or internal guidelines outlining their approach to risk management, relevant responsibilities and the procedures for approving risky transactions. Banks must *inter alia* identify, mitigate and monitor their operational and legal risks (cf. Art. 9 para. 2 Swiss Banking Ordinance, BO; SR 952.02). In addition, all banks are responsible for setting up an effective system of internal control (Art. 9 para. 4 BO).

In conducting group supervision, FINMA also investigates whether the financial services group or conglomerate can assure that business is conducted in a proper manner and is structured in such a

way as to enable it to identify, mitigate and monitor all material risks associated with the business activity (cf. Art. 3f BA and Art. 14a BO).

In Circulars 08/24 “Supervision and internal control – banks” and 08/21 “Operational risks – banks”, FINMA has laid down principles of risk management for banks, securities dealers and financial services groups and conglomerates.

There are virtually identical rules applying to securities dealers (cf. Art. 10 para. 2 let. a and let. d and Art. 10 para. 5 of the Stock Exchange Act, SESTA; SR 954.1; Art. 19 para. 3 and Art. 20 para. 1 of the Stock Exchange Ordinance, SESTO; SR 954.11). The Collective Investment Schemes Act (CISA; SR 951.31) and Collective Investment Schemes Ordinance (CISO; SR 951.311) also contain provisions on assuring proper management, organisational structure and risk management (cf. Art. 14 para. 1 let. a and c CISA and Art. 10 para. 2 and Art. 12 para. 3 CISO).

Archive

Further observations: Rules applying to insurance companies

As outlined above, to enable FINMA to assess insurance companies engaging in foreign operations as part of the licensing process, a business plan must be submitted to which the licence(s) granted by the relevant foreign supervisor(s), or an equivalent certificate, must be appended (cf. Art. 4 para. 2 let. c ISA). Any subsequent amendments to the business plan must be presented to FINMA (cf. Art. 5 ISA).

In relation to risk management, Art. 22 ISA provides that insurance companies must be structured in such a way as to enable them to identify, mitigate and monitor all material risks. In addition, all insurance companies are responsible for setting up an effective system of internal control (cf. Art. 27 para. 1 ISA). These requirements are further defined in the Insurance Supervision Ordinance (cf. Art. 96 ff. ISO; SR 961.011) and also apply to insurance groups and conglomerates supervised by FINMA (cf. Arts. 67 and 75 ISA in conjunction with Arts. 14 and 22 ISA).

Section IV of Circular 2008/32 *Corporate governance – insurers*, which also applies to groups and conglomerates subject to insurance supervision in Switzerland, lays down guidelines on risk management and internal control.

These requirements also apply to cross-border business conducted by supervised institutions. In a number of cases in the past, FINMA and the organisations that preceded it instigated proceedings against institutions under their supervision and penalised them for shortcomings in their treatment of risks under foreign law.

Example: Excerpt from a 2010 ruling by FINMA against a culpable bank

In 2010, FINMA issued a ruling against the Swiss subsidiary of a foreign bank which supplied services to neighbouring markets from Switzerland. Among other things, the bank had issued a large number of statements evidencing cash transactions which did not accord with the facts. Although these transactions had in fact been executed in the foreign clients' home country, they were accounted for as if clients had personally carried out the transactions on bank premises. Pre-signed blank receipts had been used for this purpose. FINMA found that the bank was unaware, for example, of the tax and criminal risks associated with the target markets, and that it had never clarified the legal position in this regard. The bank apparently lacked the necessary awareness of risk, which in addition to other findings, resulted in a formal reprimand and fines. The relevant excerpt from the findings on the bank's cross-border business is set out below:

[…] The provisions of the Banking Act require banks to operate an appropriate group risk management system, establish an appropriate organisational structure and assure that business is conducted in a proper manner. Supervised institutions providing cross-border services are thus under an obligation to verify the supervisory requirements under foreign law at regular intervals and to identify, mitigate and monitor any associated risks. Appropriate steps must be taken to mitigate such risks, including in particular issuing guidelines on business operations permitted in the target countries. Relevant staff training must be provided. Remuneration schemes must be structured in such a way as to promote and not penalise proper compliance (FINMA Circular 10/01 Remuneration schemes, margin no. 36). Compliance with such guidelines must be monitored appropriately. If necessary, banks must adapt their business models and refrain from engaging in business in certain markets. […]

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3.2 Criminal law

Under applicable Swiss law, Swiss financial institutions and their employees cannot be prosecuted in Switzerland for participating in the commission of tax offences by their clients in relation to foreign tax authorities. Anyone within Switzerland who manages or assists in managing assets which are connected with a tax offence involving the failure to declare the income accruing from such assets will generally receive full immunity from criminal prosecution in Switzerland. However, the Swiss Federal Supreme Court has also previously intimated that this is not an absolute rule. In addition, the rule is variable to the extent that individuals who forge documents or misrepresent the facts may also render themselves liable to prosecution in Switzerland.

The thinking behind this rule is that tax offences are crimes or misdemeanours against foreign governments, and Switzerland is reluctant to use Swiss *criminal law* as a mechanism of law enforcement in relation to the tax claims of foreign states. Arrangements already exist for mutual legal and administrative assistance in such matters. Having incorporated OECD standard 26 into its double taxation agreements, Switzerland will provide administrative assistance in cases of tax evasion. The procedure is now regulated in the Ordinance on Administrative Assistance under Double Taxation Agreements (ADV), which entered into force on 1 October 2010.

4 FINMA’s expectations

4.1 Introduction

FINMA believes it is essential, in view of developments in recent years, for supervised institutions to conduct a thorough *assessment* of their current cross-border financial services operations with respect to the legal framework and the associated risks. Subsequently, suitable measures to mitigate or eliminate risk are to be taken. In its capacity as supervisor, FINMA expects institutions to take due account of foreign supervisory legislation in particular, and to define a service model appropriate for each individual target market.

Further clarification is provided below of the expectations FINMA has with respect to the primary issue of cross-border financial services. In addition, the ongoing supervision of institutions in future will be increasingly focused on FINMA’s expectations. FINMA will also ensure that due account is taken of the distinctive features of the various categories of supervised institutions.

4.2 Conducting thorough assessments

FINMA expects the relevant financial intermediaries being addressed here to conduct a thorough assessment of the legal and reputational risks associated with their cross-border operations, both at the level of the institution itself and at group level. In conducting such assessments, supervised institutions must familiarise themselves with all their target markets and the foreign legal provisions which apply to them. The actual activities must be checked for compliance, and associated risks must be identified, mitigated and monitored.

The assessment should focus primarily on *cross-border financial services business*. The assessment should not just capture risks to which financial intermediaries are directly exposed in relation to cross-border asset management or insurance services, but also the risks potentially arising from other areas of business, such as cross-border payment transactions. Due consideration must also be given to risks posed to financial groups or conglomerates in connection with cross-border financial services provided by subsidiaries based outside Switzerland. It is essential for intermediaries to identify and evaluate the risks described in section 2, since only an integrated approach to risk mitigation and/or elimination will be effective.

The organisational structure of the institution and group and any other relevant circumstances should be factored into the assessment. Legal and reputational risks may be greater, for example, where a financial intermediary or group has an authorised onshore presence in a country to which it also supplies cross-border services, is listed on the stock exchange in that country, or has a large proportion of its assets there. There are also specific risks associated with an intermediary’s systemic importance, the structure of the main investors, agreements entered into with government agencies (e.g. QI agreements or future FFI agreements), the processing of payment transactions, the maintenance of relationships with certain correspondent banks, staffing and remuneration policies etc. All or any of these factors may place institutions or groups under a duty to initiate further action.

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4.3 Measures to mitigate and eliminate risk

Once the legal framework has been assessed and the risks been evaluated, appropriate measures must be taken to mitigate and eliminate risk.

This may lead to changes in strategy. Following a proper assessment of the situation, institutions may decide to dispense with cross-border services in certain target markets, or the provision of services to certain categories of client, and to adjust their business models accordingly. Many Swiss institutions have decided for risk-related reasons, for example, to stop doing business altogether with certain categories of U.S. clients or to at least discontinue some of their services to them.

Measures at the operational level include, in particular, issuing guidelines on business operations that are permitted or proscribed in the target countries. Relevant staff training must be provided. Compliance with guidelines must be monitored and a clear and effective system established for pursuing any breaches. Remuneration schemes must be structured in such a way as to promote and not penalise proper compliance, in conformity with margin no. 36 of FINMA Circular 10/01 *Remuneration schemes*. It is also necessary to assess whether it is appropriate to make organisational changes, for example by aggregating clients within country desks. Where necessary, cross-border or onshore licences should be obtained, or appropriate disclosures made to foreign supervisors.

FINMA does not regard the outsourcing of the management of client relationships to external asset managers as an effective means of mitigating or eliminating risk. It expects the supervised institutions to which this applies to also take due account of the risks potentially generated by external asset managers, intermediaries and similar service providers. Due care must therefore be exercised in selecting and instructing such partners.

Further observations: measures to establish the beneficial owners of insurance wrappers

Pursuant to margin no. 34 of the Agreement on the Swiss banks' code of conduct with regard to the exercise of due diligence (CDB 08), financial intermediaries domiciled or having their registered office in Switzerland are not required to provide declarations of beneficial ownership in respect of accounts and custody accounts held at Swiss banks. The same applies to financial intermediaries domiciled outside Switzerland which are subject to an equivalent level of supervision and regulation in relation to money laundering and terrorist financing. Accordingly, under the CDB previously in force, Swiss banks were not obliged to establish the identity of beneficial owners of custody accounts held in the name of an insurance company. However, the insurance wrapper product model with individually managed tied assets for each client is, depending on the arrangement, hardly any different from a traditional asset management facility provided by a bank or independent asset manager from the point of view of money laundering risk. Focus is on whoever actually pays the life insurance premium, i.e. the beneficial owner. In its Newsletter 9 (2010), FINMA therefore requires banks, securities dealers and asset managers to identify the beneficial owner in the circumstances described relating to insurance wrappers, or to include identification documents from previous dealings with the beneficial owner in the account documents for life insurance.

Archive

Banks, securities dealers and asset managers are now expected to conduct their relations with providers of such products by correctly implementing the requirements for handling insurance wrappers laid down in the FINMA Newsletter. In an updated newsletter that will abrogate FINMA Newsletter 9 (2010), the supervisory authority will clearly communicate the obligations of the financial intermediaries affected. Incorporation into the CDB of the rules on handling insurance wrappers as specified by FINMA is imaginable.

Under all circumstances, insurers with business models involving insurance wrappers have an ongoing supervisory responsibility to discharge their identification obligations, even if the insurance application was submitted through another financial intermediary. They are responsible for duly verifying the identity of the client, establishing the identity of the beneficial owner if required and discharging all other obligations relevant to the business.

Archive

Further observations: U.S. tax reforms

On 1 January 2013 the *Foreign Account Tax Compliance Act (FATCA)* will come into force. From then on, U.S. paying agents will have to retain 30% withholding tax on payments from U.S. sources being transferred to foreign financial institutions, irrespective of whether the recipient of the payment is the financial institution itself, a U.S. citizen or a non-resident alien. Payments from U.S. sources include, for example, dividends, interest, rent and salaries as well as the gross proceeds from sales of U.S. securities and equity interests, which will also be subject to the 30% withholding tax. Non-U.S. financial institutions can avoid the tax by concluding a special agreement with the Internal Revenue Service ("IRS"). Under the agreement they must promise above all to verify the identity of all their clients with respect to their possible status as U.S. persons. A broad definition of "U.S. person" is applied under the FATCA. In addition to U.S. citizens, green card holders and persons with a substantial presence on U.S. territory, legal entities are also affected, especially companies with non-operational businesses in which one or more U.S. persons hold stakes exceeding a given level. Details on the regulations are still outstanding from the U.S. Department of the Treasury and the IRS; on 27 August 2010, the IRS published a first set of guidelines for review and consultation.

Putting these regulations into practice is not only likely to generate enormous costs for the financial institutions in question but also expose them to even greater legal and reputational risks as well as operational risks. The supervised institutions are called upon to clarify the applicability of the FATCA to their business at an early stage and carefully consider potential options. Management of this issue is to be included in the assessments discussed in this section and in any related measures.

For a long time now, the U.S. has levied *inheritance and gift taxes*, which should have been abolished over ten years ago. The U.S. President at that time was able to effect a ten-year extension through a new law. Owing to the time limit, inheritances and gift will not be subject to tax in 2010. However, the U.S. Congress is expected to re-instate these taxes as of 1 January 2011, while efforts are also under way to restructure these taxes to be more effective. Under the *Certain Estate Tax Relief of 2009 (U.S. Estate Tax)*, the U.S. executor of a deceased U.S. citizen's estate is obliged to report the deceased person's assets to the IRS within nine months. It is important to note here that U.S. inheritance tax

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may not only apply in the case of the death of a U.S. person, but also under certain circumstances in the case of the death of non-U.S. persons who hold more than USD 60,000 worth of securities in their custody account. The relevant issue under these circumstances is that U.S. securities are involved, which are regarded as assets in U.S. territory (*U.S. situs assets*) and are therefore subject to taxation. Consequently, the heirs of Hans Muster, a deceased Swiss citizen who was resident in Switzerland, may be liable for taxes in the eyes of the U.S. tax authorities if the deceased had more than USD 60,000 worth of U.S. securities in his custody account. Many investors and heirs may not be aware of this. The supervised institutions are called upon to identify risks in this respect and take appropriate measures. In view of this, FINMA believes it is appropriate for financial intermediaries to inform the heirs of deceased clients who have invested in *U.S. situs assets* about any applicable reporting and fiscal obligations which may apply to them. Consideration should also be given to a general disclosure for clients holding U.S. securities. In conclusion, it should be noted that the agreement governing inheritance and estate taxes of 1951 and the double taxation agreement between Switzerland and the U.S. currently in force are to be renegotiated in 2011, which could bring about a change in the legal situation and possibly a change for the better.

Further observations: dealing with Swiss and foreign sanctions law

Swiss financial intermediaries are finding themselves increasingly confronted with requirements under Swiss and foreign sanctions laws which differ in scope. This applies in particular to the latest tightening of sanctions against Iran, initiated by the U.S., the European Union and the United Nations (UN); Switzerland follows the standards set by the UN.

In FINMA Newsletter 15 (2010) on *legal and reputational risks in business dealings with Iran,* FINMA has formulated its expectations in this respect based on financial market legislation.

Archive

4.4 Accumulating the necessary expertise

Defining a service model appropriate for each target market presents a major challenge. Institutions are responsible for developing in-house or procuring the country-specific and other expertise required for such purpose. FINMA welcomes the dissemination of country-specific information through the Swiss Bankers Association and encourages any such industry initiatives.

4.5 Notification of any problems with foreign authorities

FINMA expects to be informed immediately if any supervised institution is affected by significant legal and reputational risks in connection with cross-border financial services or is contacted by any foreign authorities regarding such matters (cf. Art. 29 para. 2 FINMASA).

4.6 FINMA will address risk management as part of its ongoing monitoring activities

As part of its ongoing supervision, FINMA will increasingly focus in future on the conduct of institutions engaging in cross-border operations. FINMA will also ensure that due account is taken of the distinctive features of the various categories of supervised institution. FINMA will cooperate with institutions in implementing the *assessment process* and *related measures* and systematically monitor implementation by some institutions. The position presented in this paper will also be reflected in FINMA's future enforcement policy.

Archive