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Legal risks in cross-border private client business – a challenge for the financial centre and the authorities

Uncertainty …

Numerous incidents in the wake of the financial crisis have made foreign private clients uncertain about Swiss financial institutions. A notable example is Switzerland's willingness, under pressure from the OECD, to provide, in future, international administrative assistance in the case of tax evasion. Furthermore, the decreed disclosure of UBS client data, the step towards providing administrative assistance to US authorities as decided by the Federal Administrative Court in March 2009, and, finally, the Administrative Assistance Agreement concluded in August 2009 increased this uncertainty. An additionally important element of uncertainty has manifested itself in the obvious willingness of foreign tax authorities to purchase client data that had been stolen and, hence, clearly obtained illegally.

Various banks have responded to the pressure exerted by the US authorities by terminating their business relationships with thousands of US clients. Many of these clients may have had no tax issues. Swiss citizens resident in the USA are having difficulty finding or maintaining a banking relationship in Switzerland, a development which is most unfavourable. While it regrets these circumstances from the client perspective, FINMA must tolerate and even encourage the policy of these banks, which is justified by risk considerations. Our activities touch upon a sensitive area. This uncertainty of the participants in the financial centre and of the clients will further damage the Swiss financial centre if the tax position for foreign client deposits is not soon clarified.

… open questions ....

Numerous unanswered questions have additionally contributed to this uncertainty. One issue was the disclosure of data on a limited number of UBS clients to the US Department of Justice, as ordered by FINMA in February 2009. This was at the time the only avenue remaining to prevent, before it was too

late, a criminal lawsuit that could have threatened the very existence of the bank. For the moment, it remains unclear how this order is to be regarded under the Banking Act. That is a decision for the Supreme Court. Moreover, the political front has still to review these developments. Currently, a work group of the parliamentary control commission is working intensively on this issue. FINMA has collaborated with engagement and transparency in this investigation. The release of additional client data to the US authorities under the agreement concluded in August 2009 between the Swiss Confederation and the United States of America remains another open question. Parliament will have to debate this issue in the forthcoming summer session.

… increasing risks under foreign law ...

As one of FINMA's predecessor authorities, the Swiss Federal Banking Commission (SFBC) investigated in depth the UBS's handling of transactions in the US and issued an order against the UBS in December 2008. FINMA published the findings in a summary report in February 2009, and as a follow-up, conducted further research into the legal risks inherent in cross-border private client business at a selection of financial institutions. FINMA is continuing its research and has made considerable advancements in this project. Its investigation focuses on the wrap business engaged in by certain insurance companies, whereby existing bank client custody accounts are wrapped in an insurance policy, making it possible to pursue inoperative, yet fiscally problematic objectives.

Previously conducted research has shown that foreign legal risks exist in relation to supervisory, tax, criminal and civil law and to procedural provisions. They can also arise due to foreign anti-money laundering laws, which is of profound importance but cannot be expanded upon here:

- Restrictions under *foreign supervisory law* apply in particular to the cross-border provision of services as well as the marketing and distribution of products from Switzerland. Many countries impose tight restrictions on the level of access that Swiss institutions have to foreign clients. These restrictions should protect investors but at the same time tend to have a protectionist side effect. The legal risks are therefore also high, and a commensurate level of caution is required when providing cross-border services in these markets. On sober reflection, it must be concluded that the regulations of many countries already make any cross-border activity which goes beyond purely social contact and the provision of general (and not product-specific) information a hazardous undertaking.
- A second, more important complexity of risks lies in the *foreign tax law* and the *criminal law* relating to it. A financial intermediary or its employees may be liable to prosecution under foreign law by assisting foreign clients in tax offences, even though they only operate in Switzerland. Foreign tax authorities are increasingly exerting pressure not only on Swiss banks and their employees, but also on their counterparts in other countries. This does not, however, change things for the financial institutes concerned. This pressure has taken on different forms. Methods, which are to some extent very dubious, are being implemented to obtain data on taxpayers with offshore relationships. Criminal proceedings are being conducted against clients and bank employees. At the same time, various institutions are being requested to cooperate – through their amnesty programmes, for example. The institutions are responding to this pressure within the framework of the law through (legal) cooperation. Such individual solutions could, however, potentially weaken Switzerland's negotiating position in the future. FINMA believes that the fiscal

legal risks associated with cross-border private client business have increased. There is a very real risk of rendering oneself liable to prosecution and being held to account. In view of the heightened risks, one should avoid advising clients on what to do with untaxed assets. This by no means applies solely to banks or insurance companies, but also to advisors, fiduciary agents and lawyers.

… and its automatic impact on Swiss law …

The above-mentioned breaches of *foreign supervisory and fiscal law* may also be relevant under Swiss law. This is, in particular, applicable to the supervisory law implemented by FINMA. Evaluating such matters is a delicate and complex operation, however. For one thing, FINMA, like other world-wide supervisory authorities, has no legal mandate to enforce foreign law within its own borders. This applies primarily to standards that in some instances are diametrically opposed to Swiss supervisory law. At the same time, though, a violation of foreign law may breach certain Swiss supervisory standards worded in very general terms, such as the requirement to ensure the safety and soundness of business. The organisational provisions of supervisory law also unmistakably require that all risks, including legal and reputational risks, be identified, limited and monitored appropriately (Art. 9 Banking Ordinance).

These are binding provisions, and FINMA has implemented them in a number of selected cases through rulings on the treatment of foreign legal risks. FINMA has adopted a cautious approach to this sensitive area, however. It believes it is fundamentally inappropriate to further increase the foreign legal risks by creating complementary Swiss legal risks. Those who are over-hasty in calling for new domestic criminal offences or an extension of documentary offences should bear this in mind. As it stands, Swiss legislation contains the principle that contributory involvement in tax offences committed in other countries is not liable to prosecution in Switzerland.

And it should remain like this. Instead of *building up* additional risks under *Swiss* law, the whole issue should be turned around and foreign legal risks should be reduced by shrewdly working out interstate regulatory conditions.

… necessitates systematic risk management by the financial institutions ...

To prevent problems with foreign authorities, Swiss and other financial intermediaries must focus their activities on ensuring compliance with the restrictions imposed in their target markets. This relates to the whole process from the development of an onshore presence through the opening of a representative office or branch right up to the establishment of a subsidiary. At the same time, cross-border private client business is geared towards serving potential or existing clients in the target markets from within Switzerland and tailoring the offering to the products and services that are permitted in the country concerned. It frequently makes a difference under local supervisory law whether the client advisor travels to the client's country of domicile, whether he/she communicates with the client (who is located in his/her country of domicile) from the booking centre, whether the client travels to the booking centre or whether they meet in a third country. Where clients are served by external asset managers, the legal risks nevertheless remain with the custodian bank. This is a

good reason for taking a great deal of care over the selection, instruction and monitoring of business partners.

From a regulatory perspective, risk analysis must consider which cross-border services and products are permitted. With regard to tax law, the issue of contributory involvement must be addressed, as must the question of whether an institution's activities mean it is itself liable for tax in the country concerned.

Company-specific circumstances, such as additional risks resulting from having an onshore presence or employing staff of a particular nationality, must also be considered when deciding on any measures to be taken. A number of approaches are possible depending on the level of exposure involved, for example a risk-oriented approach or one geared towards ensuring strict compliance with foreign rules. The internal implementation and enforcement of the rules must also be determined.

...and justifies what the financial market supervisory authority expects from supervised institutions …

There is no getting around the fact that a compliant service model must be defined for each individual target market. This is a challenging task, not least because the provisions of tax law and other restrictions have to be taken into account in addition to those arising from supervisory law.

FINMA expects financial institutions – banks and insurance companies – engaged in cross-border private client business to apply this comprehensive risk analysis to their business model with reference to each target market and use it as a basis for implementing appropriate measures. FINMA will shortly examine whether it needs to issue a regulatory order, or whether it will be sufficient to provide banks and insurance companies with concrete specifications on an informal basis.

… and a plea to the politicians

It is up to politicians and the business community to determine the financial centre's strategy. FINMA expects, however, to see a coordinated approach designed to limit the legal risks of cross-border business and restore legal certainty through negotiated solutions with individual countries or groups of countries, and will support this to the best of its ability.

We can expect a range of consequences for supervisory activity depending on the solution chosen. Should Switzerland manage to reduce the legal risks through long-term solutions agreed in consultation with the key target countries, FINMA may set aside any additional requirements to control these risks. Should this not be achieved, or should the risks actually increase, for example if financial institutions were required to verify that their clients were tax-compliant, FINMA would be forced to massively reinforce the measures it has in place to control these risks.

In line with the Federal Council's decision at the beginning of 2010, the agreement concluded with the US authorities on 19 August 2009 is to be presented to parliament for approval. The agreement allows for the release, under administrative assistance provisions, of data on around 4,500 more UBS clients at the request of the US Internal Revenue Service. Should no agreement be reached, there is a risk of

further proceedings being instigated against not only UBS but other financial institutions as well. Ultimately, the risk of new proceedings will persist until a solution can be agreed that regulates the circumstances of all existing offshore relationships between US clients and Swiss financial institutions. Ideally, new or latent legal risks, arising from matters such as the planned Foreign Account Tax Compliance Act (FATCA) of the US Estate Tax, should also be addressed.

Conclusion

The increasing legal risks in cross-border business are a major challenge for FINMA as the supervisory authority, for the financial centre and its participants, and for the political authorities. They all have a deep-seated interest in finding long-term solutions to avert the growing threat of part of the financial centre's current business model becoming criminalised under foreign law. Focus should be placed primarily on long-term harmonisation of the interests of the financial centre, its foreign clients and their fiscal authorities. There are possible solutions. Only in this way can sustainable development in the cross-border private client business be achieved. It is essential to bear in mind that this finding is not just about UBS, nor is it just about the USA. Rather, it is about securing the long-term future of the entire financial centre.