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# Legal and Reputational Risk in Private Banking

## New Tasks for Governance and Audit

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## New Tasks for Governance and Audit

PAOLO BERNASCONI

## Overview



## Introduction

In private banking, more than elsewhere, applying good corporate governance[1] rules gains new impetus due to the introduction of the requirement for bank auditors to ensure the existence of an Internal Control System and a risk-management system. The implementation of these requirements by banks entails a tremendous invest-

[1] JEAN BAPTISTE ZUFFEREY, Private Banking Governance RDS, 126, 2007, p. 235; URS BERTSCHINGER, Governance in Finanzinstitutionen, in: Aktuelle Rechtsprobleme des Finanz- und Börsenplatzes Schweiz, Bern 2006, p. 71.

ment of financial resources and intellectual energy. Thus, the individual enterprises need to adopt new internal rules appropriate to their respective size and market, as well as manifest in the adjustment of the system of continuing training of supervisors and staff. How to prepare? First of all, by drawing up an inventory of the present sector-specific risks that goes beyond definitions and emphasizes the analysis of the recurrent real situations that are specific to the company's field of endeavor and is characterized by the behavioral interaction within the typical triangle consisting of customers, the bank and the external person in charge of the management of the clients' assets deposited with the bank.

On the other hand, at the time at which the legal or reputational risk has materialized, this analysis helps the management and auditors to assess its consequences for the assets and to determine the amount of reserves connected with it. Therefore, a precise analysis of the parameters measuring legal and reputational risks related to a specific corporation is to be considered as an indispensable tool in M&A due diligence. Today we aim to stress the need for global description[2] and more in-depth research in this area, establishing some criteria.

## I. It is raining rules and watchdogs

It is not pure coincidence that also in this case the strategy used to combat money laundering lead the way: the first definitions in a set of rules are those contained in the Report of the Basel Committee on Banking Supervision of October 2001[3]. Also in the Swiss legal system these concepts are applied to combat money laundering. Indeed, Art. 9 MLO SFBC, which entails a marginal note that reads «*global monitoring and legal and reputational risks*», contains in particular Subd. 4 which reads as follows:

> «Financial intermediaries[4] forming part of a financial group, either from Switzerland or abroad, shall allow the Group's internal control bodies and external auditors to access any information which may be required concerning specific business relationships, provided that such information is essential for the management of legal and reputational risks on a global basis.» (unofficial translation)

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[2] See as a first effort LARS SCHLICHTING, Konsolidierte Überwachung der Rechts- und Reputationsrisiken im Finanzbereich, Veröffentlichungen aus dem Nachdiplomstudium Internationales Wirtschaftsrecht der Universität Zürich und dem Europa Institut Zürich, Band 51, Zürich 2007.

[3] See Chapter II, Importance of KYC standards for supervisors and banks, http://www.bis.org/publ/bcbs85.pdf .

[4] According to the legal definition provided by art. 2 of the Swiss Federal Act on Combating Money Laundering in the Financial Sector (Anti-Money Laundering Act – AMLA), to this broad category belong not only banks, brokers and insurance companies but also asset managers, fiduciary entities, etc.

With this provision the Swiss legislator has – albeit indirectly – required not only the monitoring of legal and reputational risks but also their monitoring at the consolidated level.

The obligation to identify legal and reputational risks is deemed to be of a higher level than usual, as well as the requirement to adopt exceptional diligence measures, were explicitly set forth in the Ordinance of the Swiss Federal Banking Commission Concerning the Prevention of Money Laundering (SFBC Money Laundering Ordinance, MLO SFBC), to cover both higher-risk business relationships (Art. 7) and higher-risk transactions (Art. 8). On the other hand, with Art. 9 subd. 2 Banking Ordinance (BankO) the legislator had already adopted requirements expressly mentioning the principle of risk management, including the image and legal risks:

> «The bank shall lay down in regulations or in internal guidelines the main principles underlying the management of risks and the competencies and procedures for the approval of high-risk transactions. It shall in particular identify, limit and supervise market, credit, default, settlement, liquidity and image risks as well as operational and legal risks.» (unofficial translation)

In addition, Art. 3f subd. 2 of the Federal Law on Banks and Savings Banks (BankL) provides as follows: «The financial group or financial conglomerate must be organized so as to be in a position, in particular, to identify, limit and monitor all essential risks». These risks embrace not only the legal risks but also the compliance risk[5] as defined by cipher 97 and 98 of the SFBC-Circular 06/6 on Supervision and Internal Control[6] which reads as follows:

> «Compliance is considered the adherence to legal, regulatory and internal regulations, as well as the observance of the common standards and rules of professional conduct (97); A compliance risk constitutes the risk that a regulation, standards or rules of professional conduct may be violated resulting in legal and regulatory sanctions, financial losses or damage to one's reputation (98)».

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5 OTHMAR STRASSER, Aspekte von Compliance als Teil von Corporate Governance aus Sicht einer Bank, in: Aktuelle Fragen des Bank- und Finanzmarktrechts, Festschrift für Zobl, Zürich 2004, p. 537.

6 Effective from 1 January 2007 and to be implemented by banks after 1 January 2008. As regards the new federal rules of law concerning the audit of risk evaluations, effective from 1 January 2008, see PETER BÖCKLI, Revisionsstelle und Abschlussprüfung nach neuem Recht, Zürich 2007; DIETER PFAFF/FLEMMING RUUD, Schweizer Leitfaden zum internen Kontrollsystem, Zürich 2007.

## II. Hard and Soft Law

Risk management aims at shielding the enterprise from the detrimental material and immaterial consequences of the occurrence of risks. Taking this purpose into account, the definition of risk is kept as broad as possible, the only limitation being that of preventing it from spilling over into a purely abstract risk, which might even go beyond the ordinary course of things. Thus the term *«legal»* is now being construed in its broadest meaning in order to include all of the branches of law existing in a given country at any given time – administrative, civil and commercial as well as criminal law, regardless of the formal aspect – including soft-law rules to which also self-regulation belongs[7]. Obviously, the areas of law most often relied upon within these three broad categories will change depending on the characteristics of the enterprise in question; in any case the following are part of them:

- in administrative law:
  the rules on monitoring the professional activities under examination, primarily those affecting financial intermediaries, but also the rules governing the areas in which at least the major customers operate. Examples are a dime a dozen: the chemical, pharmaceutical, environmental, food and general commercial sectors etc., including the rules governing competition, cartels and of course tax law;
- in civil and commercial law:
  particular reference to the rules governing good corporate governance, financial products, contractual liability, etc.;
- in criminal law:
  the provisions of the Penal Code and especially the rules setting forth sanctions against white-collar crime, financing of terrorism, corruption and money laundering as well as sanctions for violating administrative rules.

Even the term *«rule»* or *«provision»* is now being used in its broadest sense, encompassing not only rules embodied in a statute, but also rules contained in writs of enforcement and implementation of statutes, extending as far as the broad area defined as *«soft law»*.

This goes obviously beyond a mere domestic vision: we are talking here of the legal risk related to the statutory structure in countries belonging to a market in which a single enterprise operates, which typically comprise the countries in which the customers live and operate, in which the corporate instruments chosen by them or by the bank or external manager operate, in which the bank or external manager operate, in which financial products are negotiated, and so forth.

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7 Federal Banking Commission, Selbstregulierung im Schweizer Finanzsektor, July 2007.

## III. New superpowers: the enforcement authorities

As for private persons and legal entities the legal risk arises in connection with an action initiated by an authority, this type of risk is seen as extending not only to sanctions enacted as a result of some criminal, civil or administrative action, but also to any procedural measures adopted by an authority – from the outset of an action to the day of the final decision – that directly or indirectly affect the substantive and non substantive interests of a single enterprise. Indeed, while on one hand, by enacting the revision of the Swiss Penal Code that took effect on 1 January 2007, the Swiss lawmakers considerably softened sanctions, going so far as to contemplate the conditional suspension of a fine, on the other hand greater media publicity is given to procedural steps such as e.g. the opening of an inquiry, or a search and seizure being carried out, which triggers a chain reaction even before the main proceedings have come to a close because other authorities also step into the fray, first of all the tax authorities and monitoring bodies which can enact provisional measures such as e.g. barring someone from the exercise of an occupation[8] or the measures contemplated by the federal laws on banks and stock exchanges[9].

For a financial intermediary the legal risk can become, in substance, heavier at the outset or during the course of the proceedings than at the time of their conclusion. In other words: the agencies in charge of gathering evidence, such as public prosecutors or a body with supervisory jurisdiction over banks and stock exchanges, very often exercise more legal power than the trial court, so that the risks are potentially more serious at a time when an authority does not yet have much evidence in hand. Adding the fact that the fear of potential market repercussions may often cause an enterprise to refrain from filing an appeal, since the final decision will be posted on the court's website; and there will be an unfavorable reputational effect even if a subsequent appeal turns out successful, because the decision of the lower court or administrative authority, and the attendant's description of the facts based on the discovery of failings or misconduct, will in any event become public. Whatever measures may be imposed, even if only temporary, in any event they will be picked up and propagated worldwide by the mass media and at the same time recorded and stored in databanks that are accessed daily by all other financial intermediaries to run an initial check on the respectability of each new customer based on prima-facie information enshrined there for eternity, considering the difficulty of having entries updated or corrected for anyone so exposed via this modern state-of-the-art-pillory. A violation of rules in the economic sector needs to be prosecuted efficiently and quickly and, likewise, consequences detrimental to the investors need to be mini-

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8 Art. 33 of the FINMA Act, german version: http://www.admin.ch/ch/d/ff/2007/4625.pdf.

9 URS ZULAUF, Procédure devant la CFB («enforcement»): drame en cinq actes et épilogue, in: Journée 2006 de droit bancaire et financier, Zürich 2007, p. 165–196.

mized as soon as possible. This requires administrative and sometimes criminal investigating and enforcement agencies to actually concentrate within themselves a number of powers which historically had always been separated: they issue their own rules through ordinances, circulars and jurisprudence and organize their implementation and application; they hand down traditional sanctions as well as procedural measures carrying equivalent weight; and finally they arrange for their own media publicity. Such authorities and agencies become real superpowers acting beyond the principle of separation of powers.

## IV. Domino effect

Nowadays every judicial or regulatory agency has the legal tools to ensure the exchange of information and documents with other agencies pursuing other proceedings in Switzerland, and often a mechanism that compels the spontaneous disclosure of information by one agency to another. Thus, a cooperation grid has emerged whereby – in the cases that are most visible because of the amounts at stake and/or the notoriety of the top-level officials involved – a measure adopted by one agency in the exercise of its procedural prerogatives becomes known to other agencies[10], which in turn act spontaneously to issue any sanctions which are within their authority. This domino mechanism even operates in favor of foreign government agencies, which may then be in a position to avail themselves of the ever more generous tools provided to them by the Swiss statutes on international cooperation between criminal, civil, administrative and tax authorities.

A typical example of a temporary measure that may involve a much higher risk than that given by a potential final penalty, is the seizure of assets which is maintained until – usually many years later – a final judgment is issued on the merits, which may lead either to the release of the seized assets or to their confiscation. Indeed, the precipitous nature of temporary measures decreed at the outset of proceedings, when the principle *in dubio pro sequestro* obtains, whereby the authority or court tends to order a seizure when only the likelihood of a basis for the seizure is given, sometimes also affects the very assets of the financial intermediary or of one of its customers who are neither directly involved in those proceedings. This holds true e.g. for bank accounts held in the name of a fiduciary company into which funds of numerous clients have converged. Indeed, even if the funds were segregated in different sub-accounts, the requesting authority often asks for evidence that will rule out even an indirect connection of third-party assets with those being targeted by the order of seizure. Thus e.g. information concerning Swiss taxpayers may emerge, which will be

[10] See for instance Art. 38 and 39 of the FINMA Act (n. 8).

forwarded to Swiss revenue authorities. Beyond these inconveniences caused to third parties, a damage may arise from the fact that the assets of the customer under seizure may have been pledged as collateral for loans granted by the financial intermediary, who will at best have to incur long and costly legal proceedings to see to it that those assets are used to secure his claims rather than to cover the claims asserted by others in unrelated proceedings.

## V. Contamination Risk

One can increasingly notice that in the case when measures or sanctions are applied against the client of a financial intermediary, the latter also feels its repercussions. In other words: when a customer's risk materializes, a similar risk and event can contaminate the interests of the financial intermediary. This is something new: it was once thought that a legal risk could only arise to the detriment of an individual or corporate entity found to have committed a violation, but in fact a legal and reputational risk may even more frequently affect a client's financial intermediary, regardless of whether or not the latter had engaged in any illegal conduct. Thus, even if a sanction is adopted against the client upon trial, the financial intermediary will examine potential legal risks on the basis of the usual checklist for any action for damages – or for liability toward the managers – initiated by creditors or investors who are, in turn, clients of the client or financial intermediary; fulfillment of anti-money-laundering requirements, such as e.g. freezing assets which, because of a sanction or decision upon trial, might be seen as the proceeds of criminal activities, even if those assets happen to be pledged to secure loans granted by the financial intermediary; consequences in terms of taxation; requests for assistance in favor of foreign criminal proceedings often heavily publicized by the media in foreign markets where the financial intermediary operates, and so forth. Once more the AML rules play a pivotal role due to the obligation to apply a level of diligence to each client proportional to the level of risk held by each client (risk-based approach)[11]. This obligation has already been experimented for a long time in the area of substantive risks, like credit risk, monetary risk etc. But when it comes to legal and reputational risk[12], the task

[11] FATF/GAFI, Guidance on the Risk-Based Approach to Combating Money Laundering and Terrorist Financing, June 2007; Basel Committee on Banking Supervision, Compliance and the Compliance Function in Banks, April 2005, http://www.bis.org/publ/bcbs113.htm .

[12] See the definition in Chapter II, cipher 11 of the Report of the Basel Committee on Banking Supervision, Customer due diligence for banks of October 2001 (http://www.bis.org/publ/bcbs85.pdf): «Reputational risk poses a major threat to banks, since the nature of their business requires maintaining the confidence of depositors, creditors and the general marketplace. Reputational risk is defined as the potential that adverse publicity regarding a bank's business practices and associations, whether accurate or not, will cause a loss of confidence in the integrity of

becomes more difficult because it implies the capacity to constantly monitor the client's behavior in order to ascertain early enough the possibility that a legal or reputational risk may occur concerning the client, which could be shifted by media or market stakeholders onto the shoulders of the very same bank. Consequently, another risk arises: the accusation by an enforcement authority that the risks connected with a specific client have not been ascertained on time or that, if ascertained, they were not managed adequately. This «*risk connected with a risk*» (or with the management of the risk) is very difficult to deal with, because only rarely does the authority manage to escape the pressure of the media to evaluate a case a posteriori. Example: the Swiss Federal Banking Commission imposed sanctions on the members of the board of the Swiss subsidiary of an Italian bank because they had granted credits (even if fully guaranteed) to five of their clients in order to acquire Bank Antonveneta shares without foreseeing that the participation in this takeover by the parent company would be violating Italian administrative rules[13].

## VI. The «Dissemination of Information» Risk

Among the legal risks one must also consider the risk of the disclosure precisely of this kind of information which is kept rigorously confidential by each enterprise in this sector, not least for commercial reasons. For instance: within any kind of proceedings – civil, administrative or criminal – a government or monitoring agency often acquires documents or testimony which bring to the fore, within the proceedings, the detailed description of the internal corporate structure, of corporate mechanisms, of chains of control and conveyance of information, of computations of the prices of individual services, of the peculiarities of given financial products, of business agreements with other similarly situated enterprises and so forth. As they emerge within the scope of a given set of proceedings, such detailed descriptions may often become available to agencies other than the one who acquired them, or even to private individuals such as creditors/claimants and victims in bankruptcy, civil and criminal proceedings and their attorneys, who are under no legal constraints with regard to the use of such precious inside information.

Thus, once a piece of information has gone beyond the walls of the secure fortress of a financial intermediary's enterprise, it is no longer possible to rein in the disclo-

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the institution. Banks are especially vulnerable to reputational risk because they can so easily become a vehicle for or a victim of illegal activities perpetrated by their customers. They need to protect themselves by means of continuous vigilance through an effective KYC programme. Assets under management, or held on a fiduciary basis, can pose particular reputational dangers.»

[13] See Decision of the SFBC of 31 March 2006 published in the SFBC-Bulletin 49 / 2006, pp. 133 ff. (http://www.ebk.admin.ch/e/publik/bulletin/index.html).

sure of such information once it lands on the desk of the agency that requested it in the first place. Obviously, one assumes that the members of the various public agencies will scrupulously observe official secrecy rules, but it is also true that every day the media report on information that has been learned in the context of proceedings. Not least because in the face of big scandals and under media pressure, as well as in *ante litteram* applications of the *name and shame* principle[14], those very same public agencies increasingly tend to officially publish the contents of their inquiries even long before the final decision on the merits. Nowadays the constitutional rules and the civil law on the protection of privacy and the statutory provisions on data protection are seen as ineffective regarding the containment of these widely-used and ill-conceived transparency mechanisms.

## VII. Quater in idem

Another typical feature of the legal risk is that it may explode with a cascade effect: as soon as an omission or an irregularity by an executive or employee of a company engaged in asset management turns up, a chain of risks is triggered. As a matter of fact, even when no intentional complicity or conspiratorial behavior can be laid against the board members or the general management or against the superior of the person who committed the misdeed, the criminal inquiry will investigate that possibility as well; and in any event a civil court or one of the many supervisory or monitoring agencies may, ex-officio or on the complaint of one of the affected clients, initiate proceedings aimed at those individuals, to look into potential negligent conduct. Add to this the risks of action not only under civil law, but under administrative and perhaps tax law as well, against the enterprise as such, and the fact that the latter could even be investigated for potential criminal liability pursuant to Art. 102 SPC[15]. While the ne bis in idem principle is always respected formally, that is not the case in reality: in the event of e.g. fraud or insider trading committed by the asset manager of a bank or finance company, the enterprise may be ordered to pay damages by a civil court, slapped with administrative sanctions by a supervisory authority, incur a criminal penalty pursuant to Art. 102 SPC and have a fine imposed against it by the authority that monitors compliance with the Swiss Banks' Code of Conduct (CDB 03). A similar fate may befall a fiduciary company in its capacity as an independent manager of assets; the only difference here is that administrative sanctions may be imposed by

[14] Art. 34 of the FINMA Act (n. 8).

[15] ROMAN GEIGER, Organisationsmängel als Anknüpfungspunkt im Unternehmensstrafrecht, aufgezeigt am Beispiel der Geldwäschereibekämpfung im Private Banking einer Bank AG, Diss. Zürich 2006.

both the supervisory authority existing under the Anti-Money-Laundering Act and the professional association of which it is a member, or by either of them.

## VIII. In dubio pro rogatoria

The media attention in turn can bring about a chain reaction owing to the combination of the anti-money-laundering obligations resting on other financial intermediaries on one hand and the rules on international cooperation between the authorities of the various countries[16] on the other hand. Personal privacy protection within the Swiss system of international cooperation is heading towards slow extinction as well, because of recent legislative amendments[17] and the development of practice and case law, now driven solely by the principle *in dubio pro rogatoria*. In order to speed up the execution of requests for assistance by foreign countries, the possibilities to appeal have been heavily curtailed. The Federal Court, for instance, denies appeals on procedural grounds, by denying proper standing to appeal or by extensively applying the requirement of immediate and irreparable damage, as in the following examples:

- a witness may not bring an appeal against a decision to forward the minutes of his or her testimony and any exhibits he or she may have produced, save in exceptional cases[18];
- the vast majority of appeals filed to oppose the participation of a foreign magistrate in the examination of bank records before an order that such records be forwarded abroad are in fact denied[19];
- appeals to contest the forwarding of minutes of testimony, documents or other evidence acquired within the framework of a Swiss criminal matter pending concurrently with criminal proceedings abroad are not admissible[20];
- although the doctrine and case law do not cease to remind (one and all) that fishing expeditions are prohibited, in practice no cases are known where this rule has ever been applied.

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16 See PAOLO BERNASCONI, Förderung der internationalen Zusammenarbeit dank der schweizerischen Normen zur Bekämpfung der Geldwäscherei – Automatic Paper and Assets Tracing, to be published by Carl Heymanns Verlag, Köln, as contribution to «Festschrift für Prof. Klaus Tiedemann».

17 Among them the one of Art. 38 Stock Exchange Act on the assistance between stock exchange supervisory authorities.

18 See Federal Court Decision (FCD) 126 II 258 cipher 2d/bb; 122 II 130 cipher 2b; 121 II 459

19 See FCD 128 II 211 cipher 2.1.; 127 II 198 cipher 2b.

20 See FCD 1A.243/2006 of 04.01.2007 cipher 1.2.

The possibility of appealing to the Federal Court decisions issued by the Criminal Federal Court with regard to judicial assistance in criminal matters has been curtailed by limiting the possibilities of appeal – by dint of Art. 84 subd. 1 of the Federal Courts Act – merely to procedurally important cases concerning the personal private sphere. This test is being construed so restrictively that it is practically impossible for it to be met[21]. The implementation of the principle of proportionality, which has finally been enshrined in constitutional law (Art. 5 subd. 3 and Art. 36 subd. 2 Federal Constitution), is inversely proportional to the number of times that it is re-evoked by doctrine and case law. Actually, its implementation in terms of the scope of evidence to be forwarded to foreign authorities has in practice been made impossible by the so-called principle of «potential usefulness» according to which only those evidentiary means for which it has been possible to provide the certainty that they will not even potentially be useful for purposes of the pending foreign criminal proceedings will not be forwarded abroad. The bar for this has been set so high as to make it practically unattainable. And as if this was not enough, a foreign magistrate who applies for judicial assistance needs merely add money-laundering as a qualifying offense, for then he does not even have to fully describe the alleged predicated offenses leading up to the money laundering[22].

## IX. Swiss-Cheese Risk

Finally, laws and practice inspired by *favor rogatoriae* contemplate so many exceptions to the privacy rules that they have been transformed into the most traditional Swiss cheese[23]: many unpredictable holes. In the face of the evolution in this field it must be concluded that while bank and securities exchange secrecy continue to be enshrined in Art. 47 BankL and 43 Federal Act on Stock Exchanges and Securities Trading (Stock Exchange Act/SESTA), the exceptions contemplated in the last subdivision of these two Acts keep growing. Also, it is not only the broader doctrinal and practical interpretations that extend the scope of exceptions to bank secrecy, but also the clear-cut improvement of the quality of the documentation financial intermediaries must supply with regard to their clients, i.e. the records documenting the identity of the

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21 See FCD 1C.125/2007 of 30.05.2007; 133 IV 125, 129, 131, 132.

22 See FCD 1A.36/2005 of 29.04.2005 cipher 2.5.; 1A.111/2004 of 29.06.2004; 121 II 241 cipher 3 c.

23 The more financial intermediaries are bound to keep record of clients' information, the more such records are available for investigation by authorities. About the practice concerning the extension of the professional category of financial intermediaries see the chapter entitled «Vom Gruyère zum Emmentaler?», DINA BETI, Geldwäschereibekämpfung im Nichtbankenbereich – eine Standortbestimmung, in: Nobel (ed.), Aktuelle Rechtsprobleme des Finanz- und Börsenplatzes Schweiz, Berne 2007, p. 45.

contracting party and of the ultimate beneficial owner, their personal, family, corporate and professional profiles, the investment profile, the internal email correspondence, the contents of minutes documenting their visits, the reports drawn up by the compliance officer especially in the performance of his task of special clarification and the contents of compulsory (Art. 9 AMLA) or optional (Art. 305ter subd. 2 SPC) communications. All of these documents contain highly privileged information regarding an individual client and his or her transactions. Notwithstanding, the client actually has no possibility of verifying the accuracy and truthfulness of this information and – what is even worse – the client's possibility of preventing such documentation from being acquired by judicial and administrative authorities within the framework of Swiss proceedings or in the interest of proceedings pending abroad is in practice very limited indeed.

## X. Subsidiary Equals Branch?

Many Swiss banks have offered their clients the possibility of transferring their deposits to foreign entities owned by the banking group, particularly in Singapore. If these entities are branches, their supervision is subject to Swiss law as well. This also holds true for subsidiaries to the extent that corporate decisions – especially regarding investments – are actually made by the parent company in Swiss territory[24]. However, legal and reputational risks must be managed at the consolidated level[25], and the same applies to the compliance risk[26], even with regard to «sister» companies controlled by the same shareholders of the bank. Consolidated supervision, in turn, implies that the parent company has access to the information required to that effect, and the outside auditors as well as the supervisory authority monitor the compliance with this requirement. However, the following issues remain controversial:

- resolving the conflict between the above-mentioned requirements and current provisions on data protection and banking secrecy both in the parent company's and in the subsidiary's country;
- the possibility for creditors to have assets in foreign subsidiaries seized[27].

On the other hand, the imperative of diligent and faithful performance of the mandate requires that the customer be advised with respect to the bank's policy on the internal exchange of information that concern him, as well as with regard to internal

[24] See SFBC decision on the Bahamas subsidiary of a Geneva bank (SFBC Bulletin 49, 2007, pp. 6, 13).

[25] See Art. 4quinquies BankL; Art. 9 subd. 2. 2 BankO.

[26] See Art. 9 subd. 4 MLO SFBC; Art. 3 f subd. BankL.

[27] GEORG ZONDLER, Schweizer Arrest auf Vermögenswerte im Ausland?, AJP 5/2005, pp. 573 ff.

freezing of assets and mandatory reporting by the parent company or subsidiary when above-normal risks with regard to their respective clients arise. Insufficient transparency on these highly sensitive issues entails a risk of regress by the customer involved.

## XI. Tax Risk

From the point of view of tax law, the bank incurs a direct, legal and/or reputational risk among other things in the following instances[28]:

- in the event of violation of the prohibition against providing assistance to tax violations committed by customers pursuant to Art. 8 of the Agreement on the Swiss banks' code of conduct with regard to the exercise of due diligence (CDB 03)[29] ;
- in the event of violation of the obligations contemplated by Art. 12 Federal Act of 17.12.2004 implementing the bilateral Agreement with the EU on the European withholding tax in effect since 1.07.2005, e.g. if employees of a bank lend actual assistance in the management of one of the thousands of off-shore companies set up to act as holders of funds previously held in the name of clients residing in the EU;
- when a bank manages funds of foreign taxpayers knowing that they are evading foreign taxation by using one of the highly popular schemes involving wholly or partially bogus invoices; some foreign prosecutors consider such a cooperation as punishable.

An indirect risk arises when a tax risk vs. a client becomes topical, e.g. when the bank can become the target

- of criminal inquiries conducted and coercitive measures imposed in the event of fraud and also of tax evasion by the Special Investigative Division of the Federal Revenue Service[30];
- of current requests for judicial criminal-law assistance, but also under the much stricter rules contemplated by the bilateral Agreement with the EU to combat fiscal fraud and other similar violations to the detriment of the financial interests of the EU, ratified by Switzerland on 17 December 2004;
- of SFBC procedures when there is lagging diligence connected with the increased risk related to deposits of clients who engage in professional smuggling and simi-

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28 See URSULA CASSANI, Infractions fiscales et blanchiment d'argent, Journée 2004 de droit bancaire et financier, Basel 2005, pp. 13 ff.

29 http://www.swissbanking.org/en/1116_e.pdf .

30 Based on Art. 190 ff. of the Federal Direct Income Tax Act.

lar activities, where money laundering is punished on the strength of the FATF/OCDE Recommendations of June 2003[31].

## XII. The SPV Risk

The use of off-shore companies (Special Purposes Vehicles) as nominees of deposits managed by the bank or by external managers carries specific risks, too, beyond the well-known generic ones[32], due to the fact that the real client does not have a direct contractual relationship precisely because he chose a wind-screen that would justify his not maintaining a personal relation with the bank and instead preferring to deal with one or more persons acting in trust for him. This constellation is typically found in controversies arising between client and bank for various reasons, e.g.:

- the external asset manager is often also a director of the SPV or an authorised signatory for the account: this gives him many concurrent powers and also exposes the client to an increased risk of poor conflict-of-interest management[33] especially when the bank kicks back money (as volume discounts, finders fees) to the manager[34];
- the bank finds it difficult to fulfil the requirement to keep the real beneficial owner properly informed because it does not – and indeed cannot – have any direct contact with him, since he is a third party in terms of the contractual relationship[35], e.g. in the event of inheritance[36] or of poor management of the assets on deposit by the external manager.

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[31] See Chapter I/3 of the draft dispatch adopted by the Federal Council on the Implementation of the revised FATF/GAFI Recommendations of 15 June 2007, http://www.efd.admin.ch/00468/index.html?lang=en&msg-id=13079&lan= .

[32] See FATF Study entitled «The Misuse of Corporate Vehicles, Including Trust and Company Service Providers», 13 October 2006, http://www.fatf-gafi.org/dataoecd/30/46/37627377.pdf; SILET/DREW, Offshore Asset Protection Trust: Tax Planning or Tax Fraud?, Journal of Money Laundering Control, Vol. 5 N. 1, p. 9.

[33] Pro multis EDDY WYMEERSCH, Conflicts of Interest, especially in Asset Management and MARC KRUITHOF, Conflicts of Interest in Institutional Asset Management, in: THÉVENOZ/BAHAR, Conflicts of Interest, Zürich 2007, pp. 261 ff., 277 ff.; BRIGITTE HOFSTETTER, Das Compliance-Konzept zur Verhinderung von Interessenkonflikten innerhalb von Universalbanken, AJP/PJA 1/2002, p. 27.

[34] CHRISTINE CHAPPUIS, La restitution des profits illégitimes, le retour, in: De lege ferenda: réflexions sur le droit désirable en l'honneur du professeur Alain Hirsch, Genève 2004–, pp. 341–348; FCD 4C.432/2005 of 22.03.2006; SANDRO ABEGGLEN, «Retrozession» ist nicht gleich «Retrozession»: zur Anwendbarkeit von Art. 400 Abs. 1 OR auf Entschädigungen, die an Banken geleistet werden, insbesondere im Fondsvertrieb, SZW, vol. 79(2007), pp. 2, 122–134.

[35] BENNO DEGRANDI, Die Bank zwischen Kontoinhaber und wirtschaftlich Berechtigtem, in: Aktuelle Fragen des Bank- und Finanzmarktrechts: Festschrift für Dieter Zobl, Zürich 2004, p. 233.

## XIII. Secure Safes?

The discovery of stolen or forged works of art, contracts[37] between bribe-dispensing companies and corrupt employees, stolen or forged securities, shares, bonds, deeds of guarantee or pledge in bank vaults or safe-deposit boxes deserves ample media publicity as well as an investigation aimed at ascertaining the good faith of the items' recipients. We are faced here with a very high reputational risk not only for the custodian of those items but also for the financial system of a country; indeed, the time-honoured iron-clad secrecy surrounding the contents of safe-deposit boxes could well corroborate the notion of protection being offered to criminal individuals or organisations. For the time being we go no further than running anti-terrorist metal-detection scans. Some more adequate self-regulation might perhaps yet stave off more government intervention, probably by means of the FATF.

## XIV. Conclusions: Only Flawless Clients and Soothsayer Bankers admitted?

The inevitable clash between economic freedom and regulation is still ongoing; self-regulatory compromise satisfies neither regulators – because it does not prevent the onslaught of financial disasters – nor the business community – because the violation of self-regulatory provisions entails consequences that are hardly similar to the violation of statutory rules. Thus, authorities and law experts look for new solutions by applying economic rules to public regulation[38]. A succinct inventory of the manner in which authorities apply the rules covering the management of the legal and reputational risk in private banking and related areas shows that the search for a *«better regulation»* can draw great benefit from the implementational analysis made by the administrative authorities and by the courts as well as by the prosecutors, especi-

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[36] MARIO GIOVANOLI, Jurisprudence de droit privé, Journée 2006 de droit bancaire et financier, Genève 2007, pp. 143, 144.

[37] Sometimes the same notary who was helpful in drawing up such kind of contracts keeps on deposit the text of the contract sealed in an envelope with the mention «Handed to the public notary in a sealed envelope to be handed out only with the consent of all parties». This is another matter which deserves deeper analysis by the supervisory body of the Bar or Notaries' Association.

[38] See the Directives of the Federal Finance Department and of the SFBC as well as the bibliography in Bernet Beat, Finanzmarktregulierung im Licht von «Law and Economics», in: Nobel (ed.), Aktuelle Rechtsprobleme des Finanz- und Börsenplatzes Schweiz, Bern 2007, pp. 39 ff.

ally those set up in recent times[39]. Because this analysis is still in its infancy[40], the impact of research on «*better regulation*» is still minimal so that the «*better implementation*» sought by the marketplace remains an illusion. Indeed, the new discipline covering legal and reputational risk is reminiscent of the doctrine about the so-called «*irreproachable activity*» required for eligibility[41] to be licensed as a financial intermediary: a concept that lends itself to being stretched at will by the authorities and which may ultimately lead to the absurd requirement to accept only customers who provide a guarantee of irreproachable activity and to select only directors or managers who are good crystal ball readers.

[39] E.g. the newly introduced organisation of the office of Federal Prosecutor introduced on 1 January 2002 under the so-called «Effizienzvorlage» on one hand and, on the other hand, the new Financial Market Authority/FINMA under the Financial Market Authority Act (n.8).

[40] See as a first referece work: SABINE KILGUS, Effektivität von Regulierung im Finanzmarktrecht, Zürich 2007, pp. 115–176.

[41] See art. 3 subd. 2 lit. c; art. 3 f BankL; art. 10 subd. 2 lit. d SESTA; art. 24 subd. 1 lit. c cipher 2 AMLA.