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

On 22 October 2010, the Swiss Financial Market Supervisory Authority ("FINMA") released its position paper on legal and reputational risks in cross-border financial services. The position paper outlines the legal and reputational risks arising from the breach or circumvention of foreign rules and regulations that apply to certain activities (e.g. the supply of services or sale of products) in the financial services area and provides guidance on how FINMA expects supervised financial institutions to deal with such risks.

Addressees of the position paper

The position paper is of relevance for banks, insurance companies, securities dealers and license holders subject to prudential supervision under the Collective Investment Schemes Act which are supervised by FINMA and engage in cross-border financial services business. FINMA defines "cross-border financial services business" as all activities, services or product ranges offered to clients resident in a third country ("foreign clients"). Therefore, both operations transacted by Swiss-based institutions with foreign clients (traditional offshore business) and business models involving the provision of services to foreign clients by foreign arms of Swiss financial institutions fall under the scope of the position paper.

Legal and reputational risks in cross-border financial services

According to FINMA, the legal and reputational risks in cross-border financial services have increased considerably in the past years due essentially to more systematic enforcement. The main potential sources of legal and reputational risks in relation to cross-border financial services business are the following:

Regulatory law:

- The failure to comply with foreign regulatory rules applicable to the provision of cross-border financial services or to the supply of financial products in a foreign market (which may strongly differ from Swiss rules), e.g. regulated activities of banks such as cold calls or the offering of securities services targeted at foreign clients, or the authorisation and disclosure requirements for insurance products, may result in the concerned Swiss institutions being subject to administrative sanctions or even criminal proceedings abroad. A breach of regulatory law may furthermore give rise to civil liability under the concerned foreign law and result in clients contesting or cancelling their agreements with the financial services provider.

- Under Swiss law, only the Insurance Supervision Act explicitly requires undertakings subject to

insurance supervision in Switzerland to strictly comply with applicable foreign regulatory law when active abroad. Even though Swiss regulatory law does not contain any further comparable direct duty to comply with foreign law, a breach of foreign legislation may nevertheless result in a violation not only of certain Swiss supervisory rules which are set out in general terms (in particular the requirement to assure that business is conducted in a proper manner, "Gewähr für einwandfreie Geschäftstätigkeit" / "garantie d'une activité irréprochable"), but also of organisational rules that require financial institutions to control all risks (including legal and reputational risks) and put in place an effective system of internal control.

Tax and criminal law:

- Under foreign tax and criminal law, financial intermediaries and their employees are at risk of becoming involved (e.g. as an inciter) in tax offences committed by clients under foreign law (cf. UBS case in the US). Frequent cross-border marketing activities in certain jurisdictions may furthermore result in a financial intermediary becoming subject to foreign reporting rules, corporate tax liability or withholding tax regulations, and may also trigger a duty to disclose information on clients in accordance with the concerned foreign law.

- Under Swiss law as currently applicable, a Swiss financial institution and its employees cannot be prosecuted in Switzerland for participating in tax offences committed by its clients against foreign tax authorities. It is however important to note in this context that the Swiss Federal Court has already indicated that this basic principle is not unalterable and, furthermore, that forgery of documents as well as misrepresentation of facts is subject to prosecution in Switzerland.

Conflict of laws and procedural law:

- As a result of consumer or investor protection, courts may apply the lex fori instead of recognising the choice of jurisdiction and choice of law clauses stipulated in the terms and conditions of business. In this context, the revised Lugano Convention on jurisdiction and the enforcement of judgments in civil and commercial matters that is due to take effect on 1 January 2011 should be borne in mind, as it will, among other things, enable clients to file a law suit in their home country if the financial institution has "directed" its services towards this country and member state.

FINMA's position

FINMA clearly indicates in its position paper that it expects supervised institutions (individual financial intermediaries as well as groups) to a) *thoroughly analyse* their current cross-border financial services activities with respect to the legal framework and the associated risks, and b) *take appropriate measures* to mitigate or eliminate risks as required. Hence, institutions must give due consideration to foreign supervisory legislation in particular, and develop a service model appropriate for each individual target market.

Thorough analysis:

- Supervised institutions must carefully analyse their global activities and target markets as well as the foreign legal provisions applicable to them.

- An assessment of actual business carried out abroad must be undertaken with respect to compliance, and the associated risks must be identified, mitigated and monitored.

- Importance should be attached not only to risks to which the concerned entities are directly exposed in relation to cross-border asset management or insurance services, but also to risks that may arise from other business areas, such as cross-border payment transactions.

- Furthermore, risks to which financial groups or conglomerates are exposed in connection with cross-border financial services provided by subsidiaries based outside of Switzerland also need to be taken into consideration.

Appropriate measures:

- Based on the outcome of the global risk analysis, business models may need to be adjusted and the provision of services to certain categories of clients (e.g. US clients) or even certain target markets may need to be abandoned.

- As regards operational measures, guidelines would need to be issued on permitted or unlawful business operations in the target countries, and an adequate training of relevant staff is required.

Compliance with the issued guidelines has to be controlled and breaches punished.

- FINMA explicitly mentions that it does not consider outsourcing to external asset managers, intermediaries and similar service providers as an effective means of mitigating or eliminating risk (quite to the contrary, it expects the supervised entities to also take into consideration the potential risks generated by such external service providers). Therefore, selection and instruction of external partners must be undertaken with due care.

- Organisational changes (e.g. country desks) need to be taken into consideration.

- Where required, authorisations need to be obtained from or appropriate disclosure made to the competent foreign authorities.

- FINMA must be immediately notified if a financial institution incurs significant legal or reputational risks in connection with cross-border financial services or is contacted by a foreign regulator regarding such matter.

Monitoring by FINMA

Although the treatment of risks under foreign law by Swiss-supervised institutions has in the past already been the subject of regulatory scrutiny (and, where required, intervention), the position paper makes it clear that FINMA will from now on increase its focus on the conduct and risk management of institutions engaging in cross-border operations.

Given that the position paper only sketches the main lines of the new regulatory stance, it remains to be seen how exactly FINMA will incorporate this position in its ongoing supervision and enforcement policy. In time, its practice will define what is expected of the supervised institutions in individual cases. In an effort to alleviate the uncertainty related to the implementation of these "new" requirements, FINMA indicated that it intends to cooperate with institutions in implementing the assessment process and related measures and systematically monitor implementation by some institutions.

Contacts

The content of this newsletter is for information purposes only and does not constitute a legal advice or opinion. Should you require specific advice in this matter, please get in touch with your usual contact at ALTENBURGER or with one of the below authors of this newsletter:

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