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Swiss Federal Banking Commission

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Regulatory challenges for Swiss banking secrecy

Introductory Remarks

I will have to start with a few **disclaimers** in order to avoid any misunderstanding before entering into the sacred ground of Swiss banking secrecy from a supervisory perspective:

- The Federal Banking Commission **fully supports our Government's position** that the core content of bank customer secrecy is not negotiable, which in essence means that it will not be disclosed in tax matters, except for tax fraud. As supervisors, we are well aware of the banking sector's substantial contribution to the national economy and the impact of any fundamental change in this framework on the commercial basis of cross-border private banking[1]. Hence, my subsequent remarks are not directed at tax issues or the controversy about the second round of bilateral negotiations with the European Union on interest rate taxation, customs fraud, the Schengen or Dublin agreements, all subjects that in any case are outside the Banking Commission's remit. The emphasis is on **regulatory, not fiscal challenges** to bank customer secrecy.

- The Federal Banking Commission is **not in charge of the legislation process** in the financial sector. The Federal Finance Department has the lead function for preparing any legislative amendments and for submitting a bill to the Federal Council and ultimately Parliament. The Commission can only make suggestions to the Finance Ministry. Our public announcements and my following remarks on the necessity to change the Stock Exchange Act have to be understood in this context. We are not attempting to usurp legislative powers but merely highlighting the consequences of legal impediments and putting forward some ideas for remedial action. Why do it in public? The answer is very simple and frank: If we could not even get some understanding and support from the banking

[1] As for my own credentials in this heavily debated area, I refer to a long interview on the main Swiss national radio station: Schweizer Radio DRS, "Samstagsrundschau" of 26 January 2002.

community, it would be extremely difficult to get a majority in the parliamentary process on subjects which are at the same time **highly technical** and **politically sensitive**. We clearly prefer to reach a consensus with the banking industry as the main party concerned by a regulatory change before making concrete proposals to the Finance Department. Neither you nor we are keen to provoke a fierce political battle in Parliament and distorted media headlines, which could unnecessarily undermine customer confidence. Hence, we follow the established route: hold bilateral discussions in groups of technical experts, consult with the board of the Swiss Bankers' Association and hopefully reach a compromise at the end. When the gap between the initial positions of the two sides is large, an additional effort has to be made to better explain one's own concerns and motives to a wider circle of top managers. Today's conference is an excellent opportunity for such an exchange of views among professionals of the banking sector.

- **Foreign banks** constitute an important part of the Swiss banking sector and contribute significantly to its success story. Your 30ieth anniversary is a vivid testimony of this fact. We are proud to have you here and we congratulate you on your jubilee. As a host country supervisor to your institutions, we are fully aware of the specific cross-border nature of most of your organisations, the support from the parent and the need for close cooperation with the respective home supervisors. However, in our day-to-day work, we consider you above all on the merits of your business activities as Swiss banks and compare you with your peers of the Swiss dominated banking population. And at least part of the regulatory challenges affect all banks in Switzerland alike, irrespective of the domestic or foreign origin of their owners.

- A final disclaimer: What I am going to say, may not necessarily please you. But it perfectly fits the title chosen by the organisers of the conference: it could indeed be a ride in **choppy waters**.

After these clarifying initial statements, I am going to elaborate on **three regulatory or supervisory challenges** to Swiss banking secrecy: The first and most extensive part is dedicated to the exchange of customer-related information between securities regulators by way of international administrative assistance, which is by far the most serious and urgent issue (I). It concerns all banks and securities firms in Switzerland, whereas the other two subjects are specific to institutions, which – like most of your members – are subsidiaries or branches of foreign banking or financial groups and thus are subject to consolidated supervision by the home country. I will look at the problematic legal framework for on-site inspections by the home supervisor on the one hand (II), and give some clarification on the conditions for cross-border information flows from the Swiss subsidiary to the foreign parent or group on the other hand (III).

I. International administrative assistance between securities regulators

The Swiss Federal Act of 24 March 1995 on Stock Exchanges and Securities Trading (SESTA or Stock Exchange Act[2]) entered into force on February 1, 1997. It made securities regulation a federal matter and designated the Federal Banking Commission as the supervisory authority, expanding its traditional role as supervisor for banks and investment funds almost to a single regulator, except for insurance. We have thus – among other new tasks – been charged with the **supervision of the Swiss securities markets** in our own right as well as with **providing information to our foreign counterparts** for investigations of suspected abuses on their markets. After five years of experience with the new Stock Exchange Act, we are in a position to make a critical assessment of its strength and weaknesses. The thorny experience with our own investigations and enforcement actions on the domestic turf[3] naturally has raised our awareness and understanding for the practical needs and limitations of foreign securities regulators who submit their information requests to us. Cooperation and exchange of information among securities regulators is not a one-way-street!

Art. 38 SESTA provides the legal basis for the exchange of information between the Swiss Federal Banking Commission (SFBC) and foreign securities regulators by international administrative assistance[4]. The Commission is authorised to transmit non-public information and documents to a foreign supervisor only if three cumulative **conditions** are met:

1. The foreign supervisory authority uses the information exclusively for the purpose of direct supervision of the exchanges and securities trading (principle of **speciality**)
2. It is bound by official or professional secrecy (principle of **confidentiality**)
3. The foreign supervisor may pass on the information to other authorities only upon prior consent of the Banking Commission (principle of the **long arm**). It is not permitted to pass on information to law enforcement authorities or criminal courts if mutual assistance in criminal matters[5] would be excluded, which means in particular that the condition of dual criminality and the exclusion of tax offences (except tax fraud) apply. On that issue the Commission has to decide in accordance with the Federal Office of Justice.

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[2] Bundesgesetz über die Börsen und den Effektenhandel (BEHG, Börsengesetz); Loi fédérale sur les bourses et le commerce des valeurs mobilières (LBVM, Loi sur les bourses); SR 954.1

[3] Franz Stirnimann, Market Supervision – Opportunities and Limits, presentation given at the annual press conference of the Federal Banking Commission on 25 April 2002, available on the Commission's website in German and French.

[4] In German: Amtshilfe; French: entraide administrative.

[5] German: Rechtshilfe in Strafsachen; French: entraide judiciaire en matière pénale.

In addition, a special **procedural requirement** has to be observed by the Banking Commission: if the information to be transmitted concerns **individual customers** of a bank or securities firm, a **formal administrative procedure** applies. The customer is a party to the procedure, has the right to be heard, may request that the Commission issues a formal decree and can appeal against the Commission's decision to the Federal Court, which is the Supreme Court of Switzerland. Under normal circumstances, such an appeal will be granted a suspending effect until the final ruling of the Federal Court. This **customer-related procedure** seems to be a unique Swiss feature in the universe of securities regulation; at least our partners in the industrialised world do not grant similar rights to customers of their financial institutions.

At first sight, Art. 38 SESTA looked like a reasonable Swiss compromise, designed to achieve several **objectives**:

- Allow a direct exchange of information between securities regulators. This direct communication was supposed to be swifter, more flexible and efficient than the rather lengthy, in this context somewhat artificial route via mutual assistance in criminal matters.
- Prevent an abusive use of administrative assistance in order to evade the stringent conditions of the mutual assistance procedure in criminal matters, especially for tax purposes.
- Grant customers an equal level of legal protection – a kind of Rolls-Royce defence - as in the mutual assistance procedure in criminal matters.
- Generally, the whole concept of Art. 38 SESTA and similar provisions in the Banking Act and Investment Fund Act is very much inspired by the model of mutual assistance in criminal matters.

After five years of intensive experience and many decisions of the Federal Court, we have to acknowledge that this complex legislative framework is **fundamentally flawed** and **unsuitable for international cooperation** in the area of market supervision. Before entering into the problems, let me give you some **statistical data** that illustrate the **practical importance** of customer-related administrative assistance covered by the Stock Exchange Act since 1997:

- 21 foreign securities regulators have submitted 228 information requests to the SFBC concerning roughly 700 customers.
- The SFBC issued 118 formal decrees of which 73, i.e. more than half, were appealed against to the Federal Court. It is big business for lawyers.
- In its 62 decisions taken so far, the Federal Court has approved the exchange of information in quite a few instances, but it has also partially or fully granted the appeals in 34 cases.
- A majority of cases concerned suspected insider trading or price manipulations, but there were other market abuses, securities fraud and violations of disclosure rules as well.

- The SFBC itself has addressed 15 requests to 7 different foreign supervisors. This manifest imbalance reflects the importance of Swiss banks as cross-border investment managers.

Art. 38 SESTA received an almost **fatal blow** with the Federal Court's decision of 20 December 2001 concerning an information request by the US Securities and Exchange Commission (SEC) for suspected insider trading before the public take-over bid of **ABB for Elsag Bailey**[6]. The Federal Court ruled that the conditions for granting administrative assistance to the SEC were generally not met for two reasons:

1. The SEC cannot itself impose sanctions against investors who are not directly subject to its prudential supervision as financial intermediaries. Instead it has to file a lawsuit in a civil court. Pursuant to the US Constitution such a court procedure is **public**. In our Federal Court's view, this public procedure constitutes a violation of the principle of **confidentiality** and indirectly also of the principle of **speciality**, since the publicly available information on the customer could be used by third parties for other purposes, especially in tax matters.
2. The SEC, according to a long standing practice, publishes the introduction of its court actions in a so called **litigation release**, naming the defendants and the suspected violations, and posts the release on its website. For our Federal Court this is an even more blatant violation of the afore-mentioned principles as the website can be accessed from all over the world, e.g. from the tax authorities of the customer's country of residence.

As lawyers, we fully understand the Federal Court's legal reasoning and in general do not criticize the Court's rulings under Art. 38 SESTA. But the result is **paradox**: When the SEC had previously received the information on customers under the US-Swiss mutual legal assistance treaty (MLAT) via the judicial authorities, it followed exactly the same domestic procedure before US courts and made litigation releases; just the website didn't yet exist. But now, it is not allowed to use the information received from the Banking Commission via administrative assistance. The Federal Court concludes that only the legislator could change this admittedly unsatisfactory situation. As a consolation, the Court indicates that the old route under the MLAT could still be open to the SEC, but one should not take such an obiter-dictum for granted. However, one fact is clear: the customer-related **exchange of information from the SFBC to the SEC has come to an end** under the present law and we are back to square one. The Titanic has hit the iceberg, the Atlantic-ocean cannot be crossed via the faster northern route and going southwards again could lead into similar icebergs.

[6] See SFBC-press release of 23 January 2002

It is already dramatic enough, when providing information to the regulator of the world's largest securities markets is no longer possible under the Stock Exchange Act. However, the problems of our legislation are **by no means limited to the United States**. With the CONSOB of Italy we are also blocked at present and could soon encounter similar deadlocks with other important partners. Without going into the intricate web of legal details, let me just list the **main stumbling blocks** and explain our **ideas for amending Art. 38 SESTA**.

1. Confidentiality

Not only the SEC, but also most other securities regulators - including the Banking Commission – have to cooperate with other domestic authorities when taking enforcement actions against market abuses or other violations of their securities regulation. All supervisory authorities also have a legal obligation to report criminal offences to law enforcement agencies or prosecutors. The organisation of the authorities, their respective competences and the procedures vary from country to country, but sooner or later they all end up in a **court procedure** which – in a democratic state of law - is public, especially if it is before a criminal court. Consequently, one has to accept that the principle of confidentiality is **limited** by public procedures and legally authorised publications on enforcement actions. On the other hand, a supervisor has to keep secret all information on customers, for which he has determined that they are either innocent or not relevant for his investigation. From our own investigations we know, that only a **tiny fraction** – maybe 5% - of all the transactions initially under investigation are ultimately considered to reach the level of founded suspicions which merit an enforcement action or a criminal referral. Confidentiality also means that data may not be disclosed to any third party without a specific legal basis.

2. Principle of speciality and long arm

At its initial stage, an insider investigation is by nature a **fishing expedition**. Typically, you basically have only two elements to start with, on the one hand a publicly announced event, such as a merger or take-over bid which has a material effect on the stock price, and on the other hand an observation of increasing volumes and price movements prior to the announcement. In principle, all the transactions executed in that critical period preceding the event are **potentially suspicious**. Only when you know the identity of the originators or beneficiaries of these transactions you can start to distinguish between possible insiders and people who acted for other motives. The investigation has to be lead by the authority that is responsible for the supervision of the market on which the securities are listed and transacted. If the transaction was made through a domestic bank or securities firm, you get the information on the customers directly from that institution without long formalities. However, if the investor acted via a financial intermediary located in another country, you depend on the administrative assistance of your peer in that country.

The Federal Court has taken this situation into account to the extent that it considers a mere **initial suspicion** as sufficient for a **transmission** of the customer's identity to the foreign supervisor. It also ruled, that it is **not up to the Banking Commission** to examine which of the transactions are doubtful, let alone to determine if indeed an offence had been committed by the customer concerned. The Commission as requested authority is not in possession of the information needed for such a decision, because only the requesting authority in charge of the investigation has the full oversight and details.

However, when the foreign supervisor wants to **retransmit** the information received from the Banking Commission to a second authority, the Federal Court imposes the condition of an **additional suspicion** that has to be more concrete and probable. This condition for the Commission's approval under the long arm principle is **practically never met at the stage of the first request** made by the foreign supervisor. How could he prove a higher probability of suspicion without knowing the identity of the customer, if getting to know that identity is precisely the purpose of his request? The cases are rare where the Banking Commission itself can detect the insider quality of a customer in a foreign investigation; ABB / Elsag Bailey was one of those lucky strikes but failed on other grounds. Of course, one could overcome this higher hurdle by a **two-step approach**: first issue a decision on the transmission to the foreign supervisor and make a second decision on the approval for retransmission when the requesting supervisor has provided additional proof. Unfortunately, this doesn't work for two reasons:

1. Two subsequent formal procedures, every time with an appeal to the Federal Court, would be unacceptably long.
2. Several foreign authorities feel under a strict obligation under their legislation to immediately report suspicions to their prosecutors and cannot enter into a commitment to get the Banking Commission's prior approval, let alone if this approval is subject to a lengthy appeal procedure.

The only realistic solution to this problem is to simply **drop the principle of the long arm** for any enforcement action under the foreign securities market regulation. The foreign securities regulator should thus be entitled to retransmit the information to other competent authorities in his country, if this is necessary for the enforcement of the securities regulation, without having to get the Banking Commission's specific prior approval. The **principle of speciality** would still be broadly **maintained**, since the foreign supervisor would only be allowed to use the information for supervisory purposes in the securities regulation area and related criminal, civil, administrative or disciplinary procedures. However, if the foreign supervisor wished to retransmit the information for other than supervisory purposes, we can insist on the Banking Commission's prior approval, because any such unanticipated use outside the field of financial services regulation needs to be closely monitored.

3. Dual criminality requirement for criminal law procedures

One of the core principles for international mutual legal assistance in criminal matters under Swiss law is the condition of **dual criminality**, which means that an act has to be a criminal offence not only under the law of the requesting state but also under Swiss law. For violations of **insider trading** provisions the Federal Court repeatedly applied this principle in a very strict sense and has not permitted the retransmission to foreign law enforcement authorities, if the rather narrow definition of the Swiss criminal provision (Art. 161 Penal Code) was not met, especially in cases of mere **profit warnings,** not leading to a capital reorganisation, or an announcement of a profitable cooperation between two companies not leading to a merger. As a consequence, an investor can make a transaction on a foreign securities market and not get punished for a clear violation of the applicable rules, merely because he has chosen to place his order with a Swiss bank, although such a punishment would neither be contrary to the Swiss public order nor violate fundamental human rights. This obviously does not make sense and is tantamount to an **imperialist extraterritorial application** of Swiss law, something that we usually reproach to bigger nations.

We have two **remedies** at hand:

1. We can either **stick to the dogma of dual criminality** and expand our criminal law in securities matters, possibly to the level of the most "advanced" nation, not only for insider trading but all sorts of market abuses or conduct rules, in order to avoid a bottle-neck in international exchange of information and cooperation. The **price** of such a strategy would be **too high** and would force us to criminalize violations which we might not consider serious enough, also bearing in mind that criminal law is not always the most efficient weapon. If we expand our criminal law, then it should be because we consider it just and necessary for domestic purposes and not to maintain an old dogma. Insider trading clearly is one such candidate where there is a growing consensus in Switzerland that Art. 161 Penal Code needs to be more biting.
2. The more efficient and rational way to facilitate international cooperation is to **make dual criminality more flexible** in the area of market regulation. We should not demand that a foreign offence is also criminal offence under Swiss law, but merely that it falls under the broad concept of market supervision. This clearly has nothing to do with tax offences: under the Federal Law on international mutual legal assistance in criminal matters they are exempted per se (unless there is a tax fraud) and not formally linked to dual criminality. Nor does it mean that we would have to give up the concept of dual criminality in other areas.

4. Customer-related formal administrative procedure

As mentioned before, the formal procedure involving customers as parties is a unique Swiss feature and it is **less and less accepted** by our foreign counterparts, mainly because it is extremely time-consuming and holds up their investigation. From the entry of the foreign information request to the decision of the Federal Court on the frequent appeals, it takes on average **9 to 12 months**, not counting a second procedure when the appeal is granted. One should not be under the illusion that the procedures could be streamlined any further, because our lawyers apply stringent deadlines and the Federal Court is mostly very swift with its decisions, in spite of its well known overload.

We believe that this formal procedure is **incompatible** with international standards, is an unnecessary luxury and should be **abolished** or **focussed on a very limited scope**. As we have seen before, a customer claiming his innocence is simply barking up the wrong tree, because the Banking Commission can only examine whether a rather generic initial suspicion is given. He can make his case before the foreign supervisory authority in charge of the investigation and in possession of all the elements. I repeat, that ultimately only a small percentage of transactions are selected for enforcement actions. You might object that the formal procedure had its merits in the past, since the Federal Court did not agree with the Commission's more proactive interpretation and granted a substantial number of appeals. However, those grounds would be eliminated if the law were to be amended according to our ideas. Of course, the Banking Commission would still have to verify if the remaining conditions were met and possibly hear the customer, but a formal decision subject to appeal is not necessary for that purpose.

Finally, one has to separate the issue of a formal administrative procedure from the existing prohibition to transfer information on "persons who are manifestly not involved in the matter under investigation", so called **uninvolved third parties**. The typical case concerns transactions initiated by a bank officer or an external asset manager based on a **general asset management mandate** on behalf of a customer, if the customer did not participate in the investment decision nor give any advice. This prohibition can be maintained under the condition that clear and auditable firewalls are established because we have to be able to give an unconditional assurance to the requesting foreign supervisor. We would also continue our practice to apply a **de minimis exemption** for small transactions if there is no indication for "smurfing" via several institutions.

5. Conclusions

I hope to have demonstrated that Art. 38 SESTA needs same **profound amendments**. Apart from the technical aspects mentioned, there are several **general policy reasons** why the legislator should act rapidly along those lines:

1. Switzerland is an important financial center and therefore **must meet all international minimum standards in financial regulation**. The **International Monetary Fund** has recently carried out its **Financial Sector Assessment Program** in our country and published the report on its Financial System Stability Assessment[7]. The verdict was clearly positive: We were found to be in general fully or largely compliant with all the relevant financial sector standards and codes. However, one of the **weak spots** in the securities area are the rules on cross-border cooperation and exchange of confidential information, which were considered not to be fully in line with international standards, precisely for the reasons laid out before. Under the heading of recommended actions, the IMF therefore welcomes the Banking Commission's efforts to strengthen cooperation with foreign securities regulators. In the International Organization of Securities Commissions (IOSCO) Switzerland is now openly criticized and the pressure is mounting rapidly. We should avoid the **reputational risk** of finding ourselves on one of those famous black lists of non-compliant jurisdictions or to be brandished as an offshore center.
2. If we are not able to provide information to foreign securities regulators, this can have **serious repercussions on Swiss banks' access** to those foreign markets. Let me just remind you of our own legislation which stipulates as one of the licensing conditions for foreign remote-members on Swiss exchanges that their supervisory authority must be able to provide administrative assistance to the Banking Commission[8]. Similar tools exist under foreign law. Likewise, any **cross-border joint ventures or alliances among national securities exchanges** crucially depend on a satisfactory cooperation between the respective supervisors. In a period of ongoing battles for concentration and consolidation among the exchanges we have every interest not to put our own exchanges into an offside position. Let us neither forget the painful lesson of the issue on dormant accounts nor the tough sanctions imposed by US Courts against Swiss banks in the 1980ies in insider trading cases, when mutual legal assistance was impossible until we created a special MoU and our own criminal provision.
3. Many Swiss bankers still believe that **stonewalling** on every possible front best preserves the hard core of banking secrecy. In their view, loosening any of the sacred principles or firewalls, such as dual criminality or the right to a formal legal procedure, in one single area could trigger the **dams to break on all other frontiers**. One can have differing views on the best strategy and nobody claims to possess the absolute wisdom. However, you can also imagine a dam-break because the water has risen to such levels that it will inundate the whole dam, if no gate was opened to let the pressure off. Defending the Swiss position on **tax issues** al-

[7] The FSAP-Report on Switzerland is available on Internet. The results were presented at a media conference on 3 June 2002 by the President of Switzerland and Finance Minister Kaspar Villiger and representatives of the Swiss National Bank, Federal Office of Private Insurance and Banking Commission.
[8] Art. 53 Para. 1 lit. c Stock Exchange Ordinance; SR 954.11.

ready is an up-hill fight. We should not unnecessarily weaken this position by keeping an open flank on supervisory issues where we can be attacked for good reasons. It would be too easy for our critics and competitors to point their fingers at us with the argument that we were de facto protecting perpetrators of foreign securities regulations and then insinuate that Swiss banking secrecy was in general an illegitimate institution. We have seen one such attempt by some British politicians, who tried to smear Swiss banking secrecy by claiming publicly that it was an obstacle in the fight against terrorist financing. As this was utter nonsense, we had no problem to diffuse the bomb and throw it back. But it illustrates the mechanism how one can disguise economic self-interest under a moral pretext and create a juicy amalgam of tax issues, market abuse, money laundering and terrorist financing. **The best protection for Swiss banking secrecy therefore is to be clean in financial sector regulation and consequent in the fight against economic crimes and terrorism.**

4. At the Banking Commission we are not enamoured of administrative assistance and we have more than enough other work at hand. We are pleading for an amendment in this area above all in the long-term **interest of the Swiss financial center** and the institutions which we supervise.

II. On-site inspections and the private banking carve-out

Art. 23^{septies} of the Banking Act, which entered into force on 1 October 1999, is well known to you, because it specifically addresses **Swiss establishments of foreign banks** and provides a legal basis for on-site inspections by the home country banking supervisor responsible for consolidated supervision of the foreign banking or financial group. The **compromise** solution that made this piece of legislation acceptable to your Association was the so-called **private banking carve-out**: Art. 23^{septies}, Para. 4 in essence does not permit a direct access of the foreign supervisor to information *"which directly or indirectly relates to asset management or deposit activities for specific customers"*. Instead, the foreign supervisor has to request the Banking Commission to gather such customer-related information on his behalf and transmit it to him. The Commission has to apply the same formal administrative procedure as for the cross-border exchange of information under Art. 38 SESTA. The conditions that have to be met for the exchange of information under the Banking Act are almost identical. As we have seen before, this looks like a minefield, even if the problems might be somewhat different form market supervision. Above all, one must have serious **doubts about the practical feasibility** of applying the formal administrative procedure in the context of on-site inspections. Just imagine the following scenario: If the visiting foreign supervisor wished to know the identity of a particular private banking customer, he has to go home and wait for 9 to 12 months, hope-

fully gets the answer if an appeal is rejected, comes back to continue his analysis and possibly has to ask the next question on a connected account or transaction, etc. Whereas an informal intermediation of the Banking Commission during a joint examination might perhaps be acceptable to the foreign supervisor, the formal procedure clearly seems a **construction error**, even if it was a logical extension of the previously enacted legislation on cross-border information exchanges.

We do **not yet propose a legislative amendment** of the on-site inspection rules, as we do not wish to overload the package. After all, this legislation was enacted only three years ago and has not been fully road-tested or heavily criticized. We have had on-site inspections by supervisors from Denmark, the Netherlands, the USA[9] and Slovenia, Our peers were generally satisfied with the results of their high-level examinations of risk management and control systems and accepted the conditions imposed by our amended Banking Act. They acknowledged that at last getting access for on-site inspections was already a great step ahead and followed our invitation to find out on their own if a meaningful examination was possible in spite of the private banking carve-out. However, one should not mistake this pragmatic approach for a lasting approval of the system. In fact, there are strong reasons, why the **private banking carve-out will need to be amended in the medium term**:

- Since the adoption of the ICBS 1996 Stockholm paper on "The Supervision of Cross-Border Banking", which was at the origin of Art. 23^{septies} Banking Act, the **international standards have evolved**. In October 2001, the Basel Committee on Banking Supervision has published a paper on "**Customer due diligence for banks**", which sets globally applicable supervisory standards for "know-your-customer" (KYC) policies and procedures from a wider prudential, not just anti-money laundering perspective. I strongly recommend reading it, not only because many principles will sound familiar to you from our national regulation[10]. You might be less enthusiastic about the paper's section on the implementation of KYC standards in a cross-border context, from which I will only quote three crucial sentences:
  "During on-site inspections, home country supervisors or auditors should face no impediments in verifying the unit's compliance with KYC policies and procedures. This will require a review of customer files and some random sampling of accounts" … "However, safeguards are needed to ensure that information regarding individual accounts is used exclusively for lawful supervisory purposes and can be protected by the recipient in a satisfactory manner."
  As far as internal or external **auditors** of the parent bank or group are concerned, this is no problem under Swiss law, and I would also have no

[9] Federal Reserve Bank, Office of the Comptroller of the Currency, New York State Banking Department.
[10] Successful Swiss regulatory export products such as the rules on politically exposed persons (PEPs) or the identification of beneficial owners, including trusts.

hesitation to consider a special audit commissioned by the parent supervisor as being compatible with Art. 23^{septies}. However, the direct access of a **foreign supervisor** to the identity of individual private banking customers or depositors would be excluded by the present carve-out. We were of course conscious of this gap, but did not oppose the amended international standard because it is fully justified from a supervisory perspective. One simply can't adequately verify compliance with KYC standards without having full access at least to a random sample of accounts. As we know form our own experience in domestic PEP[11]-investigations, merely looking at internal manuals, organisation charts and smart presentations or interviewing a few people will not give you the full picture of deficiencies in the practical implementation.

- For the reason just given, the **Banking Commission applies exactly the same principles** in its capacity as home supervisor of the banking groups, which we supervise on a consolidated basis. In 2001 we had the external audit firms of 36 Swiss incorporated banks carry out an extensive program of **in-depth examinations**[12] in 75 subsidiaries or branches located in 12 host countries, mainly **offshore financial centers,** to verify compliance with Swiss KYC standards. We insisted that the Swiss audit firms go on-site and get access to individual customer files and identities, which ultimately were granted by all host country authorities. However, we did not request to be admitted ourselves, since the licensed audit firms are part of the Swiss supervisory system, but also because one should not ask others for more than one can offer in the reciprocal case. This certainly helped to accommodate the concerns of some host supervisors who face similar legal restrictions. In our role as a host country, we should however be flexible enough in future to acknowledge that many home country supervisors rely more heavily on their own on-site examinations.
- Finally, the private banking carve-out would be less of a problem if private banking constituted only a small part of the business activity of a particular bank. Most foreign banks in Switzerland, however, are mainly active in asset management for wealthy individuals or institutional investors. Consequently, home supervisors' direct access to customer-related information would thus be **prohibited in large parts** of the Swiss entities of their groups. This is unreasonable in a business activity where reputational and operational risks are the **key risks** which one cannot adequately monitor on a purely abstract basis.

[11] PEP = Politically Exposed Persons.

[12] "Schwerpunktprüfungen" in German, "contrôles approfondis" in French.

III. Intra-group cross-border information flows

Art. 4^{quinquies} of the Banking Act provides the legal framework for the flow of **information from a Swiss banking subsidiary** (or branch) of a foreign bank or financial group to its **foreign parent company** and ultimately its **home supervisor** for the **purpose of group internal control and consolidated supervision**. This is by far the **most important information channel** because on-site inspections or cross-border exchanges of information directly between host and home supervisor have a limited scope and are burdensome. The **first line of defence** is a group's own internal control over its cross-border establishments and this is done above all in the self-interest of the group. If the group does not have the necessary data or cannot verify compliance with its internal policies, rules and procedures, it cannot adequately manage and control its group-wide risks. Nor could we as supervisors accomplish our mission of consolidated supervision.

Art. 4^{quinquies} Banking Act authorises the Swiss bank to transmit all non-public information or documents to the parent company that are necessary for the purpose of consolidated supervision, subject to similar, but more broadly defined conditions:

- Speciality: exclusive use for internal control or direct supervision.
- Confidentiality: the parent and its supervisor are bound by professional or official secrecy.
- Long arm: no retransmission to third parties without the Swiss bank's prior consent.

The good news is: there is absolutely **no need for an amendment** of this legal provision because it is in full compliance with all international standards. However, there seem to be some **misconceptions** in quite a few Swiss subsidiaries and their foreign parents, which lead to confusing statements. One such example was the CEO of a French bank who claimed in a newspaper interview that he could not properly monitor the risk of terrorist financing because banking secrecy laws prevented his internal auditors from access to customer files in Swiss and Luxemburg entities. Hence, some **clarifications** are necessary:

1. The very reason Art. 4^{quinquies} was introduced into the Banking Act in 1994, was to create a sound legal basis for the transmission of customer-related information. **Banking secrecy is waived** vis-à-vis the group for the purpose of consolidated supervision. The **customer's consent is not required** nor does he have a right to be informed.
2. **Internal and external audit** of the group have full access to customer-related information.
3. The only issue one can argue about is the extent to which information is needed for consolidated supervision. Clearly, this is not limited to credit risks and the asset side, but encompasses the entire universe of risks

and related prudential regulation. In particular, there is **no** such a thing as a **private banking carve-out** in the group-internal information flow.

4. For internal control and consolidated supervision it is obviously **not necessary to create a centralised database or register** of all the customers of a group's cross-border establishments at the parent bank. This would be extremely burdensome for the group and expose the customers' financial privacy to excessive risks. In fact, the parent bank could not adequately protect the customers' rights against violations of the speciality principle, e.g. a raid of an intrusive tax authority or prosecutor. Therefore, such an indiscriminate, large-scale transmission of customer-data to the foreign parent bank would neither be authorised by Art. 4^{quinquies}. Nor do we expect in the opposite case – to take an example – that UBS maintains a centralised data base of the millions of customers of its US entity PaineWebber at the Swiss head office.
5. However, monitoring of reputational risks needs to be conducted for an institution on a worldwide basis. For that purpose the group has to have a **centralised risk management system,** embracing all foreign branches and subsidiaries, that is overseen by the group's chief compliance officer. The Basel Committee has stressed this principle, which you already find in the Customer Due Diligence paper, in connection with the **fight against terrorist financing**[13]**:**
   "... information would be kept at branches and subsidiaries and made available to the parent bank on request, or at the initiative of the branches and subsidiaries when the reputation or liability of the group could be threatened by the relationship. …"In the case of a relationship with a person believed to be involved in terrorism … the relationship should be disclosed to the centralised risk manager."
   In practical terms, this means that if one of your customers is on any of those famous **lists of suspected terrorists**, which we - and our peers via your parent organisations - keep on sending you, then you must not only immediately file a suspicion report to the Money Laundering Reporting Office of Switzerland (MROS) but should also inform the appropriate officer of the parent. You might have noticed that our briefs accompanying the lists, contain the standard instruction to the bank that is has to extend the search to all its foreign establishments and that we expect to be informed in case of a positive match, whereas the suspicion report has to be made according to the laws of the host country of that entity. So here again, there is **full consistency** between what we require in our role as home supervisor and what you are authorised to do under the Banking Act vis-à-vis your parent company and its duties towards the foreign home supervisor.
6. Finally, it would be clearly outside the scope of Art. 4^{quinquies} Banking Act and the purpose of intra-group information flows, if **foreign prosecutors**

[13] Basel Committee on Banking Supervision, Sharing of financial records between jurisdictions in connection with the fight against terrorist financing, April 2002, which is the summary of a meeting of representatives of supervisors and legal experts of G10 central banks and supervisory authorities on 14 December 2001 in Basel.

or other law enforcement authorities ordered the parent bank to get information from its Swiss subsidiary on its customers via this attractive informal channel. This is no supervisory objective and such requests therefore have to be made through the appropriate procedure for international mutual legal assistance in criminal matters between judicial authorities.

To **sum up** all the previous statements, one can conclude that there are indeed some regulatory challenges for bank customer secrecy, which require legislative changes in the short and medium term or simply a more consequent application of existing law. However, they do not infringe upon the core content of financial privacy. I sincerely hope that you as responsible bankers will ultimately agree with and support these modifications. This will help you to keep your boats and your passengers – the legitimate customers – out of any storm and to stay straight **on course**.