Switzerland: No Place Left To Hide – Swiss Banks Under Scrutiny From US Regulators

6 November 2013

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Lalive

The US is willing to target senior managers, lawyers and trustees

On 28 August, the Swiss Government and the US Department of Justice (DOJ) issued a joint statement announcing an 'accord' over a unilateral program launched by the DOJ and allowing most Swiss banks to seek a non-prosecution agreement (NPA) from the DOJ and pay heavy fines.

This would allow them to avoid or defer prosecution in relation to the custody of undeclared assets of former or existing US customers, or – subject to demonstrating the bank's US tax compliance in relation to each and any former and existing customers – a non-target letter (the "Program").

The Program will be available to any of Switzerland's 300 banks, save for those 14 institutions already prosecuted by the DOJ, among which are Credit Suisse, Julius Baer, Zurich Cantonal Bank and Pictet to name only a few.

The decision whether or not to join the Program lies with each bank. Participating banks will be split into four categories, depending on their degree of responsibility in relation to tax offences committed by their US customers.

The categories explained

Category 1 includes the 14 banks already under investigation and to which the Program does not apply. Category 2 covers those banks who believe they may have committed a US tax offence in the way they handled assets of US persons, and Categories 3 and 4 includes those banks who can show a clean bill of (tax) health in relation to US customers or demonstrate having an exclusively non-US client base only.

Under the Program's penalty provisions, a Category 2 bank seeking an NPA must agree to pay a penalty equal to (i) 20% of the maximum dollar value at any time of each US person's account which existed on 1 August 2008; (ii) 30% of the maximum dollar value at any time of each account opened between 1 August 2008 and 28 February 2009; and (iii) 50% of the maximum dollar value at any time of each account opened after 28 February 2009.

These dates correspond to the disclosure of the DOJ's prosecution of the first Swiss banks targeted for knowingly assisting US tax dodgers among their customers – ie when other banks should have known better than to continue assisting such customers or, even worse, welcoming US customers leaving those Swiss banks which had decided to part with US clients.

Where a participating bank shows, to the satisfaction of the US authorities, that a US account was not an undeclared account – and such account was disclosed by the participating bank to the US Internal Revenue Service (IRS) or was disclosed to the IRS within the framework of voluntary disclosure programs in the USA following notification by the Swiss Bank of such a program or initiative to the customer and prior to the execution of the NPA – then such account may be subtracted from the calculation basis of the fine payable by such bank.

The Program sets out the framework for the proposed NPAs, which may take into account factors specific to the particulars of each bank. The Swiss Bankers Association stated after the release of the Program's details: "The fines in particular are at the upper end of legally acceptable and economically bearable levels."

It is expected that the Program will not be viable for a number of smaller banks, forcing them to sell their customer base and enter into liquidation. Not participating in the Program leaves a bank at the mercy of an indictment in the US – the equivalent of a death warrant as it would inevitably be accompanied by a ban to clear dollar transfers, the freezing of any accounts held with US correspondent banks and the inability to deal with US securities altogether.

Another life-threatening consequence of a bank's indictment is that it may qualify as an event of default or a termination event under the ISDA Master Agreement, entitling the bank's contractual counterparts to early termination and close-out nettings offsetting mutual receivables, the resulting balance being payable by the debtor.

Wegelin's downfall

The Program is a further step in Switzerland's own 'Walk to Canossa' in its long-running dispute with the US. It all began in 2008 with the IRS probe against UBS and temporarily culminated in January 2012 with Switzerland's then oldest private bank Wegelin being forced to close following a guilty plea to assisting US customers to evade their US tax duties through undisclosed accounts.

The Swiss Financial Market Supervisory Authority (FINMA) then authorised Wegelin's split and the takeover of its non-US business by Bank Raiffeisen, leaving Wegelin to temporarily manage its then remaining US clients.

Wegelin's managing partners with unlimited liability were responsible for settling the legal and financial consequences arising from their US business. They agreed to pay more than $50m (£32m) in fines and profit disgorgements under a settlement with the DOJ. FINMA withdrew Wegelin's banking licence. The bank was no longer a bank.

What broke Wegelin's neck was the common belief after the UBS case among Swiss bankers that local banks without a presence in the US would not be within the reach of US authorities. What had sealed the fate of UBS – according to the common belief – was the toxic combination of on- and offshore business with US clients, which had made the bank liable to prosecution in America.

Wegelin and other Swiss banks believed that small 'Swiss-only' banks passively accepting US clients, without recommending or even allowing the use of offshore structures as shielding account holders, would remain below the radar screen of US prosecutors.

Wegelin's business model was typically based on the absence of any presence on US territory; the lack of aggressive marketing in view of targeting undeclared US clients; travel bans on bank employees to the US; a prohibition of direct communications (by email, fax, phone, letters or others) with US resident clients; and a broad use of hold mail to retain banking documentation in the bank's Swiss offices.

Wegelin was thus convinced that since the bank was complying with Swiss law, then strictly speaking it was not within the reach of US law enforcement. With this false sense of security, Wegelin and several other local Swiss banks welcomed untaxed US clients expelled from large international Swiss banks such as UBS and Credit Suisse – a policy which may now end up being lethal to a few banks.

With Wegelin, it became clear that the Swiss Government would not intervene to save banks unless they were too big to fail, such as UBS. After publishing the "white money strategy" in December 2009, the Government announced that Switzerland would become a "competitive, secure and internationally accepted financial centre that generates prosperity and pays taxes".

The management of untaxed assets was thus no longer seen as a competitive advantage but rather, as being seriously detrimental to the Swiss financial market. FINMA itself published in October 2010 a position paper on legal and reputational risks in cross-border financial services, according to which the violation of foreign laws may also newly constitute a breach of Swiss regulatory rules requiring banks to identify, mitigate and monitor all risks, including in particular those affecting their cross-border activities.

FINMA warned banks that this position paper would be reflected in its future enforcement policy. It turned words into deeds by withdrawing Wegelin's banking license. In retrospect, Wegelin came off lightly: the fine it paid amounted to about 5% of the undeclared US assets it has under custody, whereas the Program will now impose a haircut of up to 50% of such assets on participating banks. Further consolidations are expected in the Swiss banking sector within the next few months.

Lessons to be learned

The Wegelin case is emblematic of the new Swiss policy regarding tax evasion and shows that the US, in order to tackle tax evasion, is willing to prosecute not only the banks themselves, but also their upper management and third parties, such as lawyers, tax experts, fiduciaries, trustees, family offices and any person helping clients to open accounts and setting up offshore structures to hide money from the IRS.

To track down these accomplices, the US authorities use another powerful weapon: the 14 banks currently investigated in the US have been summoned to disclose so-called 'leaver lists' indicating the name of any bank to which it has sent undeclared US assets (the names of individual clients remain undisclosed, but the bank must co-operate to facilitate their future disclosure by way of mutual treaty assistance).

The same will hold true for Category 2 banks under the Program, which will similarly be requested to supply the US authorities with information on their cross-border relations, particularly with such leaver lists.

This will allow the US authorities to identify the last receiving banks holding undeclared accounts of US persons, including the names of (i) all account managers, third-party asset managers, lawyers and fiduciaries dealing with such assets; and (ii) the relevant clients of the Swiss bank, through a subsequent request for administrative assistance in tax matters.