NewsLetter

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PD Dr. Sabine Kilgus LL.M.

Unauthorised and 'Unauthorisable' Banking Activity

Authorisation of Banking Activities – A Prerequisite

In order to be authorized to engage in banking activities a company has to obtain a licence from the Federal Banking Commission ("FBC") based on the Federal Banking Act ("Banking Act"). The reason and the economic legitimation therefore is the protection of the bank's creditors, primarily and historically of the creditors of savings accounts. Once a license has been obtained a bank is supervised by the FBC.

In the meantime, the protection of the financial system as well as the esteemed reputation of the banking place Switzerland, are equivalent objectives of supervision. However, all objectives of supervision have been undermined by companies engaging in business operations similar to banking activities but which do not meet the necessary licensing requirements, such as sufficient capital, capable and honest management, adequate organisation, risk management in place, proper auditing and so forth.

Authority to Liquidate Unlawful Banks under the Banking Act

If a bank does not or no longer meet the licence requirements, the FBC has the authority to intervene and, depending on the severity of the contravention, request reinstatement of the lawful condition or, if that should not be possible, the liquidation of the company. In case of over-indebtedness the latter case is subject to the provisions regulating the bankruptcy of banks.

The measures applied and the competencies of the FBC are undisputed as far as they refer to banks which at some stage obtained a licence but in the course of their business activities ceased to meet the licensing requirements and, as a last resort, have to be liquidated. A recurring cause for debate, however, has been FBC's authority to liquidate market participants, who do not have a licence and who are unable to obtain one due to the lack of compliance with the specified requirements as stated in the Banking Act, but who are engaging in activities that might be considered to be banking activities.

In the past, the Federal Supreme Court repeatedly confirmed the competence of the FBC to trace such market participants and to subsequently liquidate them pursuant to Banking Act. Today this authority is regarded as firm practice and will be expressly endorsed in the new Federal Act, the FINMAG (Federal Act on the Financial Market Authority) which will in its entirety enter into force as of 1 January 2009.

The Crux of the Matter: When is an Activity Considered to be a Banking Activity?

Surprisingly, the Banking Act does not provide for a definition which would describe the business activities that quali-

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fy as banking activity. The legislator decided in 1934 that this should be left to the development of the market – and this has since remained the rule.

Art 2a of the Banking Ordinance in its current version connects the banking activity to the traditional borrowing-lending business: A banking activity is deemed to be given, if a company accepts deposits from the public on a professional basis or solicits these publicly in order to finance in the company's own name and for its own account, an undefined number of unrelated persons or enterprises. Such an activity is subject to the Banking Act. Since 1 April 2008 this definition includes foreign exchange trade activities, provided that customers' monies are pooled. Notwithstanding the universal bank principle which is firmly rooted in Switzerland, stock broking activities are not considered to be banking activities but broker-dealer activities and therefore subject to a separate stock broker licence according to the terms of the Stock Exchange Act. Any financial service provider active in the field of collective investment schemes (fund management companies, investment companies, asset managers of investment funds, distributors), with the exception of custodian banks which as banks are subject to the Banking Act, is also covered by separate legislation and subject to the Collective Investment Scheme Act.

Thus, bank deposits represent debt capital which, for reasons of creditor protection, require a special regime with licence application and supervision of the relevant market participants.

Nevertheless, problems of definition remain. In order to prevent that each and every contract for goods and/or services that is to be fulfilled in the future qualifies as banking activity and therefore triggers a banking license, Art 3a of the Banking Ordinance provides for a list of exceptions excluding certain activities from the qualification as banking activity despite their financing components.

Some of these exceptions are "clear" and easy to comprehend: For instance, debenture bonds that are issued in accordance with the rules of the Swiss Code of Obligations and subject to formal prospectus are not considered bank deposits, despite their debt capital characteristics. Further, creditor balances on customer accounts of external asset managers (as far as no interest is paid thereon), financial activities of intra-group financial companies of non-banking groups or activities of pension funds are not considered banking activities.

Other exceptions are not as easy to understand: For instance, there is a general exception even in case of acceptance of deposits: If deposits of less than 20 investors are accepted they are not considered to be "public deposits" or "publicly" solicited and therefore such activity does not qualify as banking activity. Further, investments (deposits) of qualified shareholders, investments of other financial intermediaries or deposits with associations, foundations or co-operatives which pursue a notional objective of mutual assistance are exempt. Finally, for purely political reasons intra-group savings companies of non-bank companies are exempt if they only accept savings accounts of employees of such group – an exemption that is difficult to understand given the fact that the employees clearly face a bulk risk with respect to their salary, the pension fund money as well as their private savings. Indeed the failed saving company of Swissair should have been triggering event enough to finally change the law. But this has not (yet) been the case.

Often companies advertise or actually accept investments (or deposits) that are linked to some kind of services, but for which they promise a kind of interest rate or "guaranteed returns" which often unrealistically exceed the market rate of interest for marketable – and risky – debenture. Such investment opportunities are often advertised as "venture capital". It does not come as a surprise that such transactions often occur in one or another dishonest form, similar to so-called "Ponzi-schemes" according to which the original investors are paid the promised returns (interest) with the solicited new deposits of other investors; the later ones, however, soon go away empty-handed due to the lack of "new customers". It is astonishing how many people cave into the temptation of making a fast buck and are pulled a fast one by such protagonists, losing their entire investment. The liquidation of such market participants often together with initiating criminal investigation against their exponents are therefore standard practice. A subsequent "legitimation" of such business activities by way of granting a licence, if at all considered by the protagonists, normally fails, as such companies could not be granted a licence because of their failure to factually comply with the licence requirements (insufficient funds, no guarantee for proper business operations, inadequate organisation etc.).

In practice, the differentiation between prohibited, virtual banking activity and permitted activity, especially in the area of financing in connection with purchase and/or service contracts, but

also in connection with certain forms of venture capital, raise a lot of difficulties. For instance, according to Art 3a lit a Banking Ordinance payments made in connection with a transfer of property or the provision of services, or as security for such transactions (escrow agency), do not constitute a banking activity. It is obvious that protagonists, who actually perform unauthorised banking activities, try to disguise them as rendering services in order to come under this exception. It is then the FBC's task or that of the investigators appointed by it, to establish all the facts of the case and to decide on whether, indeed, "real" service contracts (or performance contracts) are at stake or whether they have only been used as a cover for illicit banking activities. If the latter is the case, the FBC will base its decision on the actual transactions and pierce the veil by liquidating such market participants.

In individual cases the differentiation between activities that require authorisation and those that do not, might become a balancing act. Accordingly, it is advisable to submit the business model envisaged in an abstract form, on a "no-name basis", to the FBC duly prior to commencement of the possibly critical activity and to request a so-called no-action letter that certifies that there is no licence required on the condition that the business model submitted will afterwards be executed. ■

Controversial Revision of the Money Laundering Legislation

In the year 2003 the Financial Action Task Force on Money Laundering ("FATF") revised the recommendations concerning the prevention of money laundering. The core of the revision comprised three areas: 1. Amendment of the Recommendations so as to include the combat of terrorist financing; 2. Expansion of possible predicate offences for money laundering; and 3. Extension of the duties of care and reporting to professions outside of the financial sectors. Switzerland now has to implement and include the revised Recommendations into the national legislation:

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Implementation in Switzerland

In order to implement the revised Recommendations a draft bill had been passed which was subsequently presented for discussion and consultation. However, the Draft Bill was met with strong criticism resulting in the Federal Council's decision to review the matter once again. Since mid 2007 the new Draft Bill has been available and will most likely come into force in its new form.

The amended Recommendations will be introduced into the Swiss legislation as follows:

Additional Predicate Offences for Money Laundering

The money laundering provision of the Swiss Criminal Code (SCC) refers to assets originating from serious offences. In accordance with the SCC a crime constitutes a serious offence if it is punishable by a sentence of more than three years imprisonment.

In order for the newly defined predicate offences (trafficking in human beings, counterfeiting and piracy of products, serious trafficking and smuggling offences, insider trading and currency manipulations) to qualify as predicate offences in Switzerland, the legislator "simply" decided to increase the penalty threshold for the respective crimes – whether this is correct from a law-making policy perspective, however, could be questionable. For instance, as a consequence thereof the punishment for organised smuggling has been extended to up to five years imprisonment. Hence, organised smuggling is treated more seriously than assault or involuntary manslaughter.

Expansion of the mandate to include the combat of terrorist financing

For the purpose of expanding the Swiss money laundering legislation to include the combat of terrorist financing the Money Laundering Act was amended at certain sections by including references to Art 260quinquies SCC (provision concerning the financing of terrorism):

Pursuant to Art 260quinquies SCC it is an offence to acquire assets or to make them available, with the clear intention of financing a serious act of violence in order to intimidate the population or to coerce a state or an international organisation to perform or omit a certain act. However, a person who is (only) aware of the likelihood of terrorist financing does not incur a penalty. Likewise, "the act" is not considered a financing of terrorist crime if its objective is the establishment or re-establishment of democracy and the rule of law or the exercise or protection of a human right. A further exception is the financial support of actions which do not contradict the rules of public international law applicable during armed conflicts.

In terms of the references in the amended Money Laundering Act (MLA) the financial intermediary therefore has to establish whether the assets held on behalf of his clients serve to finance terrorism as described. However, the Bill does not prescribe how this should be done. Art 260quinquies SCC aims at subjective elements which a third party, and thus also a Financial Intermediary (FI), may hardly be able to recognise. In addition, the FI will have to make a decision on political grounds:

It is, for instance, not considered terrorist financing if the financed "terrorist crime" is aimed at the establishment or re-establishment of democracy and the rule of law or the exercise or protection of human rights. It cannot be quite understood how the terrorist acts of violence can be aimed at establishing or re-establishing democracy and the rule of law at all. The right to life, security and freedom is a human right. "Terrorist crimes" which infringe this fundamental human right cannot assist establishing the rule of law. The violation of human rights is inherently an unconstitutional situation.

Furthermore, it is not clear how acts pursuing legitimate political purposes and acts which constitute terrorist acts can be differentiated. The assessments to be made by an FI are politically explosive and could also depend on the political views of the individual. Such decision-making must be made by the policy-makers – not by a bank or an asset manager. Seemingly, the draft bill misses the mark.

New Duties of Identification

The new draft bill also provides for additional duties of identification. When establishing business relations with legal persons not only their identity but now also the identity of the person acting on behalf of the legal person must be verified.

It very well may be that money launderers often put a legal person forward as a cover for the identity of its backers. Notwithstanding, the fact that henceforth with regard to each legal person the natural person acting on behalf of the legal entity must be identified, might lead to additional, unwarranted administrative expenses in many areas. In this connection it would have been more desirable if a risk based approach had been chosen, i.e. if the duty to request identification had only been stipulated for cases in which an indication of abuse exists.

In summary, the new draft bill raises new questions rather than providing solutions to already existing problems. ■

On a personal note

We would like to congratulate M**rs PD Dr Sabine Kilgus**, LL.M., Attorney-at-Law, on her appointment as member of the Federal Banking Commission as of 1 January 2008 as well as on her election as member of the board of directors of the newly integrated Financial Market Supervisory Authority (FINMA) as of 1 February 2008. These appointments are not only in acknowledgement of her long-standing lecturing activity at the Universities of Zurich and St. Gallen and at the Swiss Finance Institute on the topics of the financial market law as well as contract and corporate law, but are also an expression of the Swiss Federal Council's trust in the professional expertise of Sabine Kilgus concerning the entire field of banking and capital market law. The new appointments which will entail interesting challenges but have, however, the consequence that within Lutz Attorneys Sabine Kilgus will in future take the position of a Consultant. We look forward to a stimulating cooperation with her. ■

We have the pleasure to announce that **Ms Irène Biber**, Attorney-at-Law, has become a partner of our firm with effect of 1 January 2008, and we are very pleased about the additional backing. Irène Biber obtained her law degree from the University of Zurich in 1986 and joined Lutz Attorneys in 1996. She is an appointed Judge for the Tenancy Court of Horgen and was Acting Judge at the District Court of Horgen for several years. ■

Congratulations also to **Mr Christopher Tillman LL.M.**, Attorney-at-Law, on the achievement of the title as Swiss Certified Specialist SBA Construction and Real Estate Law. This title stands for his knowledge and expertise as attorney in questions relating to construction, engineering and real estate law within the fields of private as well as public law. Christopher Tillman is a member of the Chamber of Independent Advisors to House-Builders and Landowners of the Swiss Real Estate Association SVIT (KUB) and of the Chamber of Certified Specialist SBA Construction and Real Estate Law of the Swiss Bar Association (SBA). ■

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