

Information Barriers in Financial Services



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1. Introduction

This article deals with the problem of conflicts of interest in the banking sector and their management through the implementation of information barriers as a possible instrument to ensure good corporate governance and compliance of a bank. Financial service providers, and in particular traditional universal banks, offer different services to their clientele. Inevitably, conflicts of interest arise that can have potentially serious effects on the clientele, investors and the (overall) market. The requirements imposed on banks by both the legislator and FINMA include, for example, the identification, monitoring and prevention of conflicts of interest, which are an integral part of a bank's compliance.

One possible instrument for preventing conflicts of interest is the establishment of so-called information barriers. Information barriers within the bank are intended to create separate areas. The aim is, on the one hand, to control information and limit the flow of information and, on the other hand, to create areas of confidentiality.

This article discusses the reasons for establishing information barriers, their design, and their potential impact. It also examines the impact of information barriers on a bank's corporate governance and the role of the board of directors, including their limitations.

2. Conflicts of interest in the banking sector

Conflicts of interest are unavoidable in the banking sector due to the role of banks as fiduciaries of their clientele, as a bank also pursues its own interests in addition to a large number of clients. The bank's fiduciary duty to its clientele derives primarily from private law and requires it to place the interests of its clientele above its own.¹ In the past, and increasingly after the financial crisis of 2007/2008, there have been calls for tighter supervision and control of banks.² In recent decades, the legal and regulatory framework has increased considerably as a result (e.g. with Basel III).³

1 Pursuant to Art. 398 para. 2 CO, the bank shall be liable for faithful and diligent performance under the contractual relationship.

2 Hopt K. J. (2017). Corporate Governance von Finanzinstituten. Zeitschrift für Unternehmens- und Gesellschaftsrecht, p. 438 et. sqq.

3 Basel III includes global regulations for the regulation of credit institutions.

Banks are subject to far-reaching statutory or regulatory reporting obligations that require a coordinated flow of information throughout the company. For this purpose, they must install a well-functioning overall organization. The organization is set up by the management respectively the board of directors, which bears the (overall) responsibility.⁴ The provision, acquisition and evaluation of information are at the heart of a bank's activities, and information management is therefore an important task for banks. By processing information, it pursues a «knowledge-based» business model.⁵ Due to the problem of conflicts of interest, it is crucial, especially for banks, how information may circulate within the company, since, among other things, the legal consequences (e.g., the question of liability) are linked to this.⁶ Generally, a «conflict of interest» is assumed when one interest is placed above another. This can lead to a classic principal-agent dilemma, in which the representation of interests cannot be the servant of two masters at the same time.⁷ In the present case, the principal-agent dilemma occurs in the relationship between bank employees (agents) and the clientele (principals).

Here, conflicts of interest can arise due to information asymmetries. Measures such as information barriers are required to reduce the information asymmetries and at the same time exploit the advantages of the division of labor between experts and laypersons.

Conflicts of interest affect not only individual bank clients, but also the market as a whole. If investors withdraw their trust in the capital market and its ability to function due to systematic conflicts of interest, this can lead in extreme cases to a shortage of capital and ultimately to market failure.⁸

The first step in identifying conflicts of interest is taken by the bank's compliance department. In order to prevent conflicts, the board of directors is responsible for various organizational measures, including the establishment of information barriers that prevent information from being exchanged between departments of the bank.

3. The instrument of the information barrier

Measures to prevent or mitigate conflicts of interest can come in different forms: At the institutional level, there is the restriction of business activities to certain areas. Here, under the so-called separation banking system, banks are prohibited from simultaneously providing all transactions or services to their clientele.⁹ Second, there are specific prohibitions directed at bank employees. Certain practices such as «churning», «front / parallel / after running» and the so-called «price cutting» are prohibited in any case.¹⁰ A measure aimed at preventing conflicts of interest is the information barrier.

Information barriers aim to limit the flow of information within the bank and prevent communication. They serve to ensure that sensitive information is not exchanged between different departments.¹¹ In other words, information barriers can be defined as measures that prevent potential conflicts of interest between the bank and its clients as a result of the flow of compliance-relevant information.

4 Pursuant to Art. 716a para. 1. cipher. 1 CO.

5 Abegglen S. (2004). Wissenszurechnung bei der juristischen Person und im Konzern, bei Banken und Versicherungen: Interessenkonflikte und Chinese Walls bei Banken und Wertpapierhäusern, Privatrecht und Finanzmarktrecht (Habil. Universität Bern 2003), p. 308.

6 Vischer M. & Galli D. (2022). Wissen, Nichtwissen und Wissenmüssen von natürlichen und juristischen Personen. Schweizerische Zeitschrift für Wirtschafts- und Finanzmarktrecht, p. 361 et. sqq.

7 Peters A. (2012). Conflict of Interest in Global, Public and Corporate Governance. Cambridge, p. 3 et. sqq.

8 Fischer D. A. (2018). Interessenkonflikte im Schweizer Privat- und Wirtschaftsrecht: Ein Beitrag zur dogmatischen Erfassung eines omnipräsenten Governance-Problems (Habil. Universität Zürich 2018, Zürich/St. Gallen 2019), p. 82.

9 Watter R. (1991). Chinese Walls bei Universalbanken?. Schweizerische Juristen-Zeitung, p. 109 et. sqq.

10 «Churning» is understood to mean the «switching of customer securities accounts without an economic reason in the customer's interest». The bank earns commissions on these additional and non-economic transactions at the expense of the clientele. «Front / parallel / after running» means that the bank buys the recommended securities itself before, during or after issuing (buy) recommendations, i.e. engages in proprietary trading. Finally, «price cutting» means that the customer is charged a lower price when buying securities than the bank achieves when executing the transaction. The difference remains with the bank as profit. For the whole see: FINMA-Circular 2009/01 N 14; Waygood-Weiner A. T. (2014). Rückvergütungen und Interessenkonflikte in der Finanzbranche (Diss. Universität St. Gallen 2013, Zürich/St. Gallen 2014), p. 47.

11 Hopt K. J. (2004). Prävention und Repression von Interessenkonflikten im Aktien-, Bank- und Berufsrecht, p. 214.

In Switzerland, the legislator does not conclusively regulate how a separation must take place. However, in practice, there is regular talk of organizational, hierarchical, functional and spatial separation.¹² This means that certain functions or departments within the bank are specifically separated from one another. In this way, the bank prevents employees who are involved in the provision of various financial services from performing tasks that do not allow for the proper handling of conflicts of interest.¹³

In this context, the separation of employees in particular comes into play. The following separation options have become established accordingly: In the case of spatial separation, separate buildings, floors or rooms lend themselves as measures. Task-related separation, on the other hand, tends to involve different legal units, departments and project groups that are to work independently of one another. Procedural separation can involve, for example, using selective distribution lists and agenda items that are only sent to a small group of employees on a need-to-know basis. Finally, mental separation is achieved with in-house education and training, which are also the cornerstones of the confidentiality areas.¹⁴

4. Sanctions

Violations of the establishment of information barriers can have consequences under private law as well as under criminal and supervisory law. This can range from claims for damages by clients¹⁵ to criminal prosecution¹⁶ and sanctions by FINMA. In particular, FINMA has the (sanction) remedy of restoring the proper state of affairs.¹⁷ In this context, FINMA can reprimand the bank in a supervisory procedure and issue mandatory measures for supervised banks. These can range from organizational requirements to professional bans for errant executives.¹⁸

It is worth noting that there are discussions at the political level about strengthening FINMA's sanctioning powers (e.g., fine powers) in order to further improve the effectiveness of supervision and enforcement of conflict of interest rules and to strengthen transparency vis-à-vis the public.¹⁹

5. Corporate Governance

Compliance and corporate governance have a special position in the banking sector in the context of preventing conflicts of interest. Compliance, as part of corporate governance, is of crucial importance to banks and significantly influences their organization and risk management.

The compliance organization has a protective function for the bank, its clientele and the market as a whole. It aims to prevent knowledge-based conflicts of interest and maintain trust in the market. A functioning compliance organization can thus increase the bank's trustworthiness in the market, which means stability for the national and global financial system. The recently completed acquisition of Credit Suisse by UBS should be mentioned here. The takeover was announced to restore confidence in the bank as well as «to protect depositors and the financial markets.»²⁰ The function of protecting confidence thus applies not only to bank customers but also to the capital market.

Corporate governance, especially in the banking sector, has evolved over time, particularly as a result of various scandals and corporate failures of global significance in the 1970s.²¹ But there have also been more recent calls for tighter regulation of banking institutions in Switzerland. One example is the Raiffeisen case, where serious deficiencies in the bank's corporate governance were identified in 2017/2018. On the one hand, the bank was reprimanded for the inadequate composition of its board of directors. FINMA stated that the bank had to ensure that «at least two members, have the required banking experience for the size of the institution».

12 Sethe R., Bösch R., Favre O., Kramer S. & Schott A. (2021). *Schulthess Kommentar zum Finanzdienstleistungsgesetz FIDLEG* (Zürich/Basel/Genf), Art. 25 N 59. .

13 Art. 25 lit. d FIDLEV, cf. Herzel L. & Colling D. E. (1978). *The Chinese Wall and Conflict of Interest in Banks*. *The Business Lawyer*, p. 90.

14 On the whole, see: Hofstetter B. (2002). *Das Compliance-Konzept zur Verhinderung von Interessenkonflikten innerhalb von Universalbanken*, p. 34.

15 Art. 398 CO.

16 Art. 158 SCC.

17 According to Art. 31 FINMASA.

18 Art. 33 FINMASA.

19 Postulate Birrer-Heimo P. (2021) retrieved from <https://www.parlament.ch/de/ratsbetrieb/suche-curia-vista/geschaefte?AffairId=20214628>.

20 FINMA, media release dated March 19, 2023.

21 Böckli P. (2022). *Schweizer Aktienrecht*, § 12 N 37; Bröker K. F. (2002). *Compliance für Finanzdienstleister, Beratungs- und Verhaltensregeln für das Wertpapiergeschäft*, p. 1.

On the other hand, FINMA criticized the lack of experience of the Board of Directors in the compliance area and required Raiffeisen to make profound and structural changes in the composition of the Board of Directors and the entire organization. Furthermore, gross violations were found in connection with the handling of potential and actual conflicts of interest, which were due on the one hand to an inadequate organizational structure and on the other hand to the overall corporate culture of Raiffeisen Switzerland.²²

The Board of Directors is responsible for dealing with conflicts of interest and, in this context, also for monitoring compliance with organizational arrangements, establishing an effective internal control system (ICS) and implementing regulations, guidelines and processes to prevent improper market conduct.²³

Finally, it is also the Board of Directors that shapes and is responsible for the strategic direction, the anchoring of compliance measures, and the bank's culture.

6. Limits of information barriers

FINMA and the Federal Supreme Court recognize in principle that information barriers are an appropriate means of preventing conflicts of interest.²⁴ Nevertheless, there are some important limitations. The Federal Supreme Court emphasizes that all material information must be brought together at the level of a bank's top management. Only in this way can the bank respond appropriately to conflicts of interest that affect the entire institution. This means that there is no perfect information barrier that works in all respects. Instead, information barriers are one part of an overall system that supports a bank's compliance.

Efficiency considerations represent another frontier for information barriers. In a competitive market such as the banking sector, business management factors play an important role. The pursuit of economic efficiency often leads to the merging of banking departments, which in turn can create conflicts of interest.²⁵

In addition, stringent regulatory requirements can interfere with banks' entrepreneurial freedom and make it difficult for them to adapt to changing market conditions. Information barriers can also hinder cooperation and limit the ability of bank employees to act. The principle of proportionality must be observed, as different sized banks face different risks and implementation options.

It is emphasized that, after all, there are always people behind the compliance measures who have to follow and monitor them. It is also pointed out that if precautions are taken to prevent certain scenarios, there are always ways to circumvent them. Therefore, it is critical to make the implementation of information barriers flexible and company-specific, while exercising the necessary caution.

7. Conclusion

In this article, the information barrier instrument was examined with regard to its suitability for managing conflicts of interest in the banking sector.

It is emphasized that conflicts of interest in the banking sector can be detrimental not only to individual clients, but also to the financial market as a whole. In response, legislators and supervisory authorities have enacted rules of conduct to regulate conflicts of interest in order to strengthen the protection of clients and maintain the attractiveness of the Swiss financial center. One of the measures to prevent conflicts of interest is the establishment of information barriers. These include both functional and personnel separations that manage and control communication and the flow of information within the bank. Implementation also includes the creation of internal guidelines and training to raise employees' awareness of correct behavior.

22 On the whole, FINMA, media release dated June 14, 2018; Raiffeisen report N 59, N 64.

23 Strasser O. (2004). Aspekte von Compliance als Teil von Corporate Governance aus Sicht einer Bank, in: von der Crone H., Forstmoser P., Weber R. H. & Zäch R. (Hrsg.). Festschrift für Dieter Zobl zum 60. Geburtstag (Zürich/Basel/Genf), p. 537 et. seq.

24 BGer 2A_230/1999 of February 02, 2000 E. 5; FINMA-RS 2013/08 N 51.

25 See fn. 8, p. 82 et. seq.

Implementing the information barriers can be challenging in practice, especially for small banks that offer (universal) services under one roof. Therefore, the implementation of these measures should be adapted to the specific circumstances of each bank. Finally, it is noted that even the best information barriers can be circumvented. Therefore, it is important not only to take formal measures, but also to create an understanding and positive culture regarding these measures. This requires continuous communication, role modeling by management and the board of directors, and finally, consistent monitoring of compliance.

This article suggests that banks and their governing bodies must work more actively to promote understanding of internal measures and regulations in order to create a banking culture free of conflicts of interest. This requires not only constant, targeted communication but also consistent sanctioning of misconduct. In addition, FINMA's sanctioning options could also be reviewed and expanded to more effectively punish misconduct by employees and managers.

Overall, this work shows that information barriers are an effective tool to manage conflicts of interest in the banking sector, but are not sufficient by themselves to ensure a functioning compliance organization. Corporate governance and the active role of the board of directors are critical to managing conflicts of interest and fostering a compliance culture. Finding an appropriate balance between information barriers and the need to share important information in the banking sector remains a challenge.