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Foreign Accounts

The Justice Department and Swiss Banks: Understanding The Special Disclosure Program



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On Aug. 29, 2013, the Tax Division of the U.S. Department of Justice announced a special voluntary disclosure program aimed at a large group of Swiss financial institutions. The program will allow an eligible Swiss bank to avoid criminal prosecution in the U.S. in exchange for detailed disclosures and, for some banks, the payment of monetary penalties. In light of the deadlines embedded in the program, any potentially eligible Swiss institution should evaluate its position and consider applying for relief by year end. This article will highlight some aspects of the new initiative and

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spot some issues that Swiss banks and other entities and individuals might face.

Context of the Deal

For the past five years the U.S. has been engaged in multi-faceted enforcement actions regarding unreported Swiss accounts. The Justice Department has pursued criminal investigations and indictments of account holders; Swiss bankers, lawyers and investment advisors; and various banks. The IRS has opened civil audits, served John Doe summonses, and implemented an Offshore Voluntary Disclosure Program ("OVDP"), which has attracted approximately 40,000 Americans who have then identified their banks and other parties involved with their unreported accounts. Its Whistleblower Office has received claims and paid one significant reward to a Swiss banker who was convicted of a felony and then served jail time. The U.S. and Switzerland (and Liechtenstein as well) have agreed to expanded and enhanced information exchange. And the U.S. is implementing the Foreign Account Tax Compliance Act ("FATCA"), which will create a global regime of automatic information disclosure beginning in 2014; the Swiss government has accepted FATCA by agreement with the U.S.

Now, the Justice Department (DOJ) is seeking to close out its issues with Swiss banks, encouraging them to come in and resolve their potential U.S. criminal exposure in connection with tax or monetary (FBAR) violations. This could allow Swiss banks to put this episode behind them, enabling them to develop an attractive and safe investment climate for the future. But for individuals, including both U.S. account holders and Swiss advisors, bankers and the like, there is an enhanced risk of future U.S. enforcement action.

The Special Program

The DOJ released two documents on Aug. 29. The first was its Joint Statement with the Swiss Federal Department of Finance. In it, the U.S. announced its intention to offer this special program, and Switzerland agreed to encourage its banks to participate, to commu-

nicate with U.S. account holders about entering OVDP, and to process expeditiously any treaty requests that would result from required disclosures.

The second was a DOJ document captioned “Program For Non-Prosecution Agreements Or Non-Target Letters For Swiss Banks,” or in shorthand, Program for Swiss Banks (“PFSB”). In substance, the PFSB provides a road map for eligible banks to obtain a nonprosecution agreement or nontarget letter. The program follows the Swiss Parliament’s prior rejection of expanded disclosure protocols for Swiss banks seeking to avoid criminal prosecution, and then the delegation to the Swiss Federal Council to permit certain disclosures. Importantly, the PFSB is conditioned on Switzerland’s endorsement and facilitation of the program, and if the Swiss government chooses otherwise, or “should legal barriers prevent effective participation by the Swiss Banks,” DOJ can terminate the PFSB.

Scope and Categories of Banks

The PFSB applies only to custodial and depository institutions. It is not open to Swiss insurance companies or most other investment entities, nor to individuals, such as Swiss bankers or advisors. Also ineligible are the fourteen banks (designated as Category 1) currently under grand jury investigation – unnamed, but thought to include Credit Suisse, Bank Julius Baer, Bank Frey, the Swiss branches of three Israeli banks, certain Kantonal banks and others.

The relevant period for information disclosure and penalty calculations begins August 1, 2008 (approximately when the DOJ’s investigation of UBS became public) and extends into 2014. Among eligible banks, Category 2 banks are those that have a reason to believe that they have committed tax or related criminal offenses under U.S. law, and they are eligible for a non-prosecution agreement (“NPA”). Category 3 and 4 banks are those that have not engaged in criminal conduct or that are “deemed compliant” under technical rules implemented under FATCA. They would receive a “nontarget letter.”

As a result of program deadlines and incentives we will discuss below, well before year end, each bank considering the PFSB must fully understand its own conduct concerning its U.S. accounts in order to ascertain, or be advised, as to whether the institution may have broken U.S. law.

Process and Timing

The PFSB sets out a rapid time frame for eligible banks to participate. The overarching driver of the deadlines is that the DOJ agrees to hold off on authorizing new criminal investigations of Swiss financial institutions until Jan. 1, 2014. After that date, DOJ can designate any bank not yet in the program as a target of a new investigation, rendering it ineligible for the PFSB.

By Dec. 31, 2013, the same date the moratorium on new investigations expires, any bank that wishes to obtain an NPA (Category 2) must submit a letter of intent to the Tax Division containing certain disclosures detailed below. Then, within 120 days, the bank must provide substantial additional information, but not the names of account holders. (A bank can obtain an extension of an additional 60 days for good cause.) Once this information is reviewed and accepted by the DOJ, the

bank is likely to receive an NPA, at which time the bank will be required to provide yet more specified data. (Banks thought to have engaged in more egregious conduct may instead face a deferred prosecution agreement.)

Banks concluding that they belong in Category 3 and 4 must wait until after the freeze on new investigations expires, and may submit their letters of intent no earlier than July 1, 2014, and no later than Oct. 31, 2014. These letters of intent must include certain information, and then later, the institution must provide additional data to obtain the nontarget letter. Importantly, the PFSB provides only limited potential relief for any bank that misses the year end deadline for an NPA but then concludes that it has culpability under U.S. law. Such banks may request consideration for an NPA, but the Tax Division, in its sole discretion, will grant relief only under “extraordinary circumstances.”

Required Disclosures

The PFSB sets forth detailed disclosure requirements for any participating Swiss bank. In the first phase – the letter of intent – each bank must describe how it intends to comply with the PFSB; identify an Independent Examiner (a qualified attorney or accountant who will certify the information provided in the PFSB process); and provide assurances as to record retention and waivers as to the statute of limitations.

For Category 2 banks seeking an NPA, the second disclosure phase is more detailed. The banks must describe how their cross-border business was “structured, operated and supervised,” and provide the names and functions of all individuals who participated in any of this activity. The bank must also indicate how it marketed its services to U.S. persons and serviced their accounts, and provide the value of accounts greater than \$50,000 during three separate periods. The PFSB prescribes an actual in-person presentation to DOJ officials, where prosecutors can follow up with questions, and banks are obligated to cooperate in answering them. Assuming all goes well, DOJ will then issue an NPA, with, as noted, the limited exception for certain egregious cases where there is “extraordinary culpability,” which may prompt a “deferred prosecution agreement” (“DPA”).

Upon receipt of an NPA, the Category 2 bank must provide yet more certified details about U.S.-held accounts, including, *on an account by account basis*, the highest value during the period beginning Aug. 1, 2008; the number of persons affiliated with the account and their functions; whether the account was held in a structure (a foreign corporation, foundation, etc.); whether it held U.S. securities; the name and role of any outside advisor affiliated with the account; and information about transfers of funds into or out of the account.

The PFSB incorporates rules and due diligence procedures from FATCA for identifying U.S. related accounts, but modifies the reporting threshold. FATCA creates two tiers of due diligence procedures for financial institutions, one for “lower value accounts,” *i.e.*, \$250,000 (as modified by the PFSB) or less and one for “high-value accounts,” above that amount. With numerous caveats, FATCA allows banks to rely primarily on searches of electronic databases to look for U.S. indicia. If any such information emerges, the account is

included in the PFSB disclosure rules unless convincing evidence is gathered demonstrating that the account would not be reportable to the U.S. For higher value accounts, more rigorous electronic and paper or manual review of relevant account files is required.

The second phase is less complicated for banks seeking a nontarget letter. They must (i) institute plans to comply with all relevant provisions of the PFSB within 120 days, (ii) identify a qualified Independent Examiner, (iii) agree to maintain required records, and (iv) waive all statutes of limitations. Category 3 banks and their Independent Examiner must then “verify the percent” of the bank’s holdings and assets that are U.S. accounts, describe the bank’s compliance program and certify that it is effective. The Examiner’s report must then disclose (i) a list of witnesses, their titles and information provided by them, (ii) a list of the files reviewed, and (iii) the Examiner’s conclusions. Category 3 banks must maintain all pertinent records for 10 years, and implement procedures to prevent employees from assisting U.S. account holders in concealing or transferring their funds. Such banks must also close all accounts of “recalcitrant” customers and agree not to open any U.S. “Related Accounts” except on conditions ensuring the account is disclosed to the U.S.

Category 4 banks avoid most of these disclosure requirements, having only to verify through the Independent Examiner that they are indeed a “Deemed Compliant Financial Institution” and maintain records sufficient to confirm that status for 10 years.

Criminal Protection

The PFSB contemplates three resolutions depending on the potential criminal exposure of the banks – an NPA, a nontarget letter and the likely rare DPA. These are largely standard documents in the U.S. justice system.

An NPA is a binding agreement between the Swiss bank and the DOJ that, based on previous cooperation and future commitments by the bank, protects the bank from prosecution. Presumably the protection will extend to any criminal tax conduct prior to the bank’s application to PFSB in exchange for the bank’s completion of the program’s requirements and its continuing cooperation. It will likely have standard clauses that limit the protection to conduct known by or revealed to the U.S. government in the PFSB and allow the DOJ to terminate the NPA upon a finding that the bank provided false information or otherwise violated the NPA’s terms.

As indicated above, if the Tax Division determines that egregious circumstances exist, it may insist on a deferred prosecution agreement instead of an NPA. The DPA is a somewhat more elaborate and public procedure, even though the results are usually the same as an NPA. A DPA protects the bank from prosecution for the conduct described therein, but the DOJ files a criminal charge against the bank and reserves the right for a set period of time to prosecute if the bank fails to meet conditions imposed by the DPA, principally continued cooperation, cessation of noncompliant practices, and future obedience to the law. DPAs are usually filed publicly with a U.S. court.

For Category 3 and 4 banks, the nontarget letter contains no binding promises. It is confirmation of a current fact – that DOJ is not investigating the bank.

Within the PFSB, however, the nontarget letter may carry more weight than normal because it will be based in part on the findings of an Independent Examiner and the acceptance of those facts by the Tax Division.

Penalty Amounts for Category 2 Banks

Reflecting the DOJ’s focus on Swiss banks that took in American clients avoiding disclosure after the UBS case began in 2008, the penalties due from Category 2 banks increase depending on when the accounts were open. For U.S. related accounts in existence on August 1, 2008, around the time when the UBS investigation became public, the penalty is 20 percent of the highest aggregate value. The penalty increases to 30 percent on accounts opened between that date and Feb. 28, 2009 (the month in which the UBS Deferred Prosecution Agreement was executed), and then to 50 percent for any U.S. account opened after that date. Importantly, the penalties can be reduced if the account was reported as required by the U.S. account holder, if the bank had already disclosed the account to the IRS, or if the account holder has entered the OVDP or does so prior to the execution of the NPA. Penalties will apparently not be reduced as to accounts reported in “quiet” disclosures, i.e. through amended or delinquent filings outside the OVDP.

No penalties are imposed on Category 3 or Category 4 banks.

Cooperation and Related Conditions

Any institution participating in the PFSB must retain all documents associated with the program and cooperate fully with the DOJ. Cooperation includes providing witnesses to authenticate bank records when needed by the U.S. in any proceeding and paying for translations. Any bank found to have submitted materially false, misleading, or incomplete information may face prosecution. These provisions are standard in agreements entered into between the DOJ and business entities when criminal cases are resolved.

Selected Issues

1. The Decision to Participate as Category 2 or Category 3

Probably most critically, the PFSB creates strong incentives for any Swiss financial institution unsure of whether it would fall into Category 2 or Category 3 to choose the former and enter the program by the Dec. 31 deadline. The Tax Division has agreed to freeze the identification of new banks under grand jury investigation only until that date. Category 3 banks are not even permitted to apply under the program until mid-year 2014, and any bank that waits that long but concludes that it should have sought an NPA faces an difficult battle to persuade DOJ to issue such an agreement. Meanwhile, any bank that misses the Category 2 deadline risks being rendered ineligible for the PFSB if the Tax Division, based on its continuing investigative activity, decides to target the bank in a new investigation.

This puts substantial pressure on the question whether a bank is “culpable” under U.S. tax law. This question has two components, i) has the *institution* engaged in criminal activity, and ii) what constitutes a criminal tax violation.

As to the first point, under U.S. law, the threshold for corporate criminal liability is low: a corporation is held to engage in criminal conduct if any employee acting in the scope of employment commits a criminal act that may benefit the company. While in practical terms, the Tax Division would more likely prosecute a business entity for pervasive conduct, as a pure legal matter the actions of one employee can trigger criminal liability. So even if a bank concludes that it may have had only one or two “rogue” employees who acted in contravention of bank policy, the bank could be deemed a culpable institution.

Then there is the definition of what constitutes a tax crime or monetary crime under U.S. law. While account holders who willfully hide money are obviously committing a tax crime or the felony of failing to report a foreign account, for purposes of a bank’s review, it is significant that U.S. law contains broad conspiracy and aiding and abetting statutes that can reach any person who willfully facilitates or assists in such conduct in any way. As should be obvious by now, the Tax Division takes an expansive view of what such conduct might entail.

Evidence of willful conduct can include the bank’s marketing practices, hold mail agreements with clients, coded communications, U.S. visits by employees, the destruction of records, the use of intermediaries, the holding of assets in foreign corporations or foundations, the deposit or withdrawal of cash, advice to transfer assets to other financial institutions with perhaps a lower risk profile, or other conduct that aided a U.S. person in hiding assets. Emails, customer logs, and other documents are often key evidence of willfulness.

The push to enter the program under Category 2 is magnified by two additional facts. First, the IRS has a substantial database identifying banks, bankers, and third party advisors who have been named by OVDP participants as involved in the hiding of accounts. Banks may know which clients are in OVDP, but they do not know what those clients have told the IRS about their employees and institutional conduct.

Second, in the case of transferred, or “leaver” accounts, there are two banks involved, one that saw the money leave and one that took the money. Either could decide to enter the program. Whether the second bank will be notified of that event by the Category 2 deadline is a matter of Swiss law. Moreover, one of the 14 ineligible banks could settle its case and provide another bank’s name as a transferee or transferor institution. Any receiving bank may be presumed to have known that the account had been unreported in the past. A bank that holds out from Category 2 is at risk that another bank will identify it as involved in an unreported account situation.

The PFSB is thus an elaborate exercise in game theory, causing each bank to wonder what evidence the DOJ will accumulate about them if they refrain from applying under Category 2. In our view, any bank that finds evidence of a potential willful and wrongful act by its employees involving a U.S. account should apply for an NPA. Penalties can be reduced if the account holder (current or former) has gone into, or decides to participate in, the OVDP. But if a bank takes the risk of trying to get into Category 3 next year, even if it avoids being targeted in a new investigation, it still faces very long odds of obtaining an NPA if the Tax Division concludes that it did in fact engage in culpable conduct.

2. Disclosure of Employees and Third Parties

The Justice Department has aggressively pursued Swiss bankers, investment advisors and other individuals who are regarded as having facilitated tax evasion by U.S. account holders. Criminal indictments have been returned against approximately 30 such persons, and several have entered guilty pleas. Some of those are believed to be cooperating with U.S. authorities.

Understandably, having to “give up” the names of bank employees and others is a point of great sensitivity and may raise issues under Swiss law. Indeed, when Credit Suisse was found to have provided information about its employees in August 2012, a Swiss court ruled that this was improper and had to stop.

Having said that, the DOJ for years has operated under policies that require any company under investigation – whether a U.S. or foreign entity – to cooperate fully in order to avoid indictment. Such cooperation has always extended to identifying employees and third parties who may have been involved in criminal conduct. In this respect, the PFSB requires nothing more of Swiss banks than the DOJ would require of a U.S. bank – or indeed any entity — under criminal investigation.

3. The Treaty Process

To obtain account holder names, the U.S. intends to submit requests for administrative assistance under the U.S.-Swiss Tax Treaty once the DOJ receives program information about U.S. related accounts. The Treaty has required the U.S. to satisfy the “fraud and the like” long standard for conduct covered by a request for information. In 2009, the U.S. and Swiss agreed on a protocol to expand this test and include tax evasion. While the Swiss have ratified the protocol, it (along with all other tax treaties) has been held up in the U.S. Senate by the actions of one Senator, Rand Paul from Kentucky.

It is no doubt an embarrassment to the U.S. that the protocol remains unratified, but the practical question is what impact this will have on disclosures sought under the PFSB. Swiss courts have ruled that any unreported account held in a corporate or foundation structure meets the “fraud and the like” standard, and although it is a matter of Swiss law, we can envision that conduct by U.S. account holders to move from bank to bank to avoid disclosure might also meet that standard. This will remain to be seen. Moreover, Sen. Paul could change his mind anytime.

Two other points concerning the treaty process warrant mention. First, any U.S. person who challenges disclosure in Switzerland must comply with section 3506 of the U.S. criminal code, which requires any such U.S. individual to so notify the DOJ and submit copies of pleadings to the Attorney General. Obviously this provision creates a “Catch 22” situation for anyone seeking to prevent disclosure of their name. Section 3506 contains no sanction for failure to comply, but U.S. prosecutors view a violation of section 3506 as an act in furtherance of tax evasion or even obstruction of justice when a U.S. person is seeking to protect information as to an unreported account. Moreover, the IRS has unequivocally determined that any such person is ineligible for participation in OVDP.

Second, some commentators in the U.S. and Switzerland have suggested that the two countries consider a Tax Information Exchange Agreement (TIEA) along the lines of the 2009 protocol. TIEAs do not require ap-

proval by the U.S. Senate, and such an agreement would enable Switzerland, should it wish to see this matter to a full conclusion, to authorize disclosure consistent with the 2009 protocol of a wider category of information than would be producible under the original tax treaty.

4. Account Holders and OVDP

It is almost certain that with approximately 40,000 U.S. taxpayers having entered OVDP, some of a Category 2 bank's accounts would be excluded from the penalty base. Perhaps more significantly, the PFSB incentivizes banks to persuade U.S. account holders to go into the OVDP, and some clients will do so. Indeed, in our experience, bank notification to customers that their identities face likely disclosure to the U.S. government, or a requirement that they demonstrate U.S. compliance or sign a Form W9 to avoid account closure, are common "last straws" leading the customer to take action. We see no reason why a participating financial institution could not threaten to close any account that has not been reported to the IRS or as to which the client chooses not to undertake a voluntary disclosure; indeed, many banks already have been communicating such a policy to U.S. account holders. As to former clients, though, there is little the financial institution can do other than to provide notice that disclosure is likely given the bank's participation in the PFSB.

Also, the OVDP's FAQs provide that the IRS can terminate or change the terms of the program at any time as to any class of taxpayers, and more specifically, the IRS reserves the right to deem ineligible for OVDP account holders at certain banks that are subject to U.S. enforcement activity. Thus, the PFSB may cause the IRS to consider whether clients of participating banks should after a point in time be ineligible for the OVDP's penalty caps. The IRS may give little or no warning before announcing this. This is just another factor that should cause both Swiss banks and their customers to ensure quickly that any holdout U.S. customers make a prompt and educated decision about entering OVDP.

5. FATCA Requirements

Switzerland and the U.S. have entered into an Intergovernmental Agreement (IGA) to implement FATCA. The PFSB borrows many concepts from the IGA, but rather than apply prospectively, as with FATCA itself, they apply back to 2008. Moreover, the PFSB prescribes obligations that go beyond the IGA. For example, the PFSB provides that Category 2 and 3 banks must close the accounts of "recalcitrant account holders." These are generally persons who (a) fail to comply with reasonable requests to determine whether the account is a U.S. account, (b) fail to provide identifying information for each "specified U.S. person" and other U.S. persons affiliated with a foreign entity, or (c) fail to provide a waiver of any foreign law, such as a domestic secrecy provision, that would prevent the bank from making required FATCA reports. The participating bank must also attempt to prevent recalcitrant account holders from otherwise concealing their accounts, and they may not open new accounts for U.S. persons without assurances of proper reporting.

6. Privilege Issues

We suspect that before deciding whether to enter into the PFSB, a bank may wish to conduct an internal review under the attorney-client privilege to ascertain its

exposure (if it has not already done so). However, if the bank then decides to enter the PFSB, it may not be able to protect the privileged nature of this internal analysis. DOJ policies do contain certain limited restrictions on the government's ability to demand privileged materials from companies under investigation, but they also require cooperating companies to disclose material underlying facts, even if those facts may have been initially discovered by the company in a privileged investigation. Thus, if a bank has previously conducted a privileged internal investigation, it may be able to maintain that privilege if it is willing to incur the costs of a new Independent Examiner. Alternatively, it may be able to use some or all of a prior analysis, but at the risk of waiving privilege.

7. The 14 Excluded Banks

As noted, the PFSB does not extend to the 14 banks currently under grand jury investigation. The cases involving those banks will be resolved either through an indictment (or information and guilty plea), a DPA, or an NPA. Most observers believe that the terms of the 2009 UBS Deferred Prosecution Agreement, and a recent NPA involving Liechtenstein Landesbank, set benchmarks as to how future cases will be resolved. The PFSB will further inform the dispositions of the ongoing grand jury investigations – for example, it seems quite unlikely that the Tax Division will offer a better deal to a bank currently under investigation as to civil penalties than is being offered under Category 2. So as the cases involving the Swiss banks excluded from the PFSB are resolved, we would expect to see a package of sanctions that is more severe than set forth in the PFSB.

8. Other Countries

Quite obviously, the PFSB is limited to Swiss banks. But it is widely known that the DOJ is investigating banks in Israel, the Caribbean, India and perhaps other countries. Swiss banks that participate in the PFSB will have to provide information on transfers, and some Americans seeking to continue to hide their money moved funds to other countries, where the U.S. government might turn next. We can envision a further increase in investigative activity outside Switzerland if the U.S. obtains significant information concerning activity in other nations.

Moreover, the PFSB could serve as a template for the U.S. to resolve cases involving financial institutions in other countries. To be sure, such agreements could differ materially with the PFSB, depending on whether, for example, a tax treaty is in place or there is a FATCA IGA. But one could envision a circumstance that involves, for example, Israel, where a few banks may be identified as targets and ineligible for a program like the PFSB, but then the U.S. announces a PFSB-like program for other banks there. Many of the same incentives would be in place for banks to participate and for bank clients to enter OVDP.

9. Violations of the Agreement

As noted, if the Tax Division determines that a participating bank provided false or misleading information, failed to provide complete information, or otherwise violated an NPA, it can prosecute the bank. Notably, these provisions do not explicitly require the bank to have acted "willfully," and the decision to revoke the protections of the PFSB is in the "sole discretion" of the Justice Department. Thus, any participating bank must

undertake every effort to make sure that information provided is true, accurate and complete. While we doubt that the DOJ will revoke an NPA or nontarget letter for an isolated mistake or omission, U.S. authorities will likely have little tolerance for material errors, and the bank at issue will not be able to prevent expulsion from the program merely on the technical ground that it did not act willfully in failing to provide truthful and complete data.

10. Confidentiality

The Tax Division is prohibited from disclosing a bank's participation in the PFSB absent the bank's consent. However, the bank may be required to notify Swiss regulatory authorities of its participation, and in any collateral or other litigation, the bank may be compelled to disclose that it had received an NPA or a nontarget letter. Moreover, a bank that obtains a final disposition under the PFSB may decide on its own to publicize that fact in order to assure customers, investors and the financial community at large that it faces no exposure from the Justice Department.

Conclusion

The PFSB is a unique, if not extraordinary, development in the long running saga over Swiss bank secrecy

and U.S. account holders. It offers the Swiss financial community, albeit at a potentially high financial cost, the opportunity to obtain closure on U.S. criminal tax issues for most of its banks and to move on from any past misconduct. Any Swiss financial institution would be well advised to give serious and prompt consideration to participating in the PFSB, and it then should evaluate objectively and carefully what track it chooses to be on.

As to individual employees, advisors, lawyers, fiduciaries and similar third parties – all not eligible for protection from prosecution in the PFSB – such persons should consider all options, including contacting the IRS and/or Tax Division to make a disclosure, avoid prosecution, or obtain the lenience traditionally associated with full cooperation if prosecution cannot be avoided.

And finally, for U.S. account holders, the lessons of the past five years remain in place. Any account holder who has not entered OVDP for unreported accounts will face pressure from their financial institution to do so, and ought, even on their own, to consider seriously whether the time has finally come to undertake a voluntary disclosure in order to avoid the risk of criminal prosecution.