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Swiss banking law upside down

Switzerland is in the process of revising its financial markets laws. The Swiss government has launched a major project which aims to amend the current framework comprehensively by enacting two new pieces of legislation. The Federal Financial Services Act (FFSA, in French – *Loi fédérale sur les services financiers* 'LSFIN', in German – *Bundesgesetz über die Finanzdienstleistungen* 'FIDLEG') will set out the prerequisites for providing financial services and offering financial instruments. The Financial Institutions Act ('FinIA', in French, *Loi fédérale sur les établissements financiers* 'LEFin', in German, *Bundesgesetz über die Finanzinstitute* 'FINIG') is to provide for a specific supervisory regime for financial institutions. The Swiss government submitted for consultation to stakeholders drafts of the FFSA and FinIA. The consultation process ended on 17 October 2014. The Parliament should discuss the drafts in 2015. The FFSA and FinIA will most likely enter into force in 2017 at the earliest.

Federal Financial Services Act

In addition to creating uniform competitive conditions for financial services providers, the purpose of the FFSA is to improve client protection by levelling the playing field. It governs the relationship between financial services providers and their clients in relation to all financial products. Clients are divided into three categories, ie, (i) retail clients; (ii) professional clients; and (iii) institutional clients, with opt-out and opt-in options. Some FFSA rules are designed for the protection of retail clients only, as they require a higher level of protection than professional and institutional clients. The FFSA provides for a code of conduct which lays out rules on suitability and appropriateness tests, the duty to inform incumbent upon financial institutions, their duty to keep written records and remit copy of documentation to clients, and their duties of transparency and care in relation to client orders. The FFSA also contains rules on: adequate organisational measures; avoidance of conflict of interests; client advisers; cross-border financial services in Switzerland; provision

of financial services subject to the obligation to publish a prospectus; the obligation to provide clients with an easily comprehensible basic information sheet; the distribution of structured products; and legal enforcement of clients' rights.

Financial services providers must abide by a code of conduct in order to provide financial services to clients. An important contribution of this code is the obligation to provide clients with information related in particular to the financial services and instruments offered, the form and manner of the custody of financial instruments and the related risks and costs. When providing investment advice and portfolio management, financial services providers shall also inform (standardised forms are allowed) their clients as to whether or not: (i) their services are provided independently; (ii) the suitability test is undertaken on an ongoing basis; and (iii) a market analysis is conducted in association with the service. Financial services providers can designate a service as independent only if: (a) they consider a sufficient range of financial instruments offered on the market; and (b) no retrocessions, kickback or any other benefits are accepted, or they are passed on to the clients. Financial services providers can designate themselves as independent only if they meet both of these conditions in relation to all the financial services they offer.

The FFSA introduces suitability and appropriateness tests in Swiss law, based on the EU's MiFID regulations. When financial services providers advise clients or manage their assets, they must take into account their clients' financial situation and investment objectives as well as their knowledge and experience in relation to the proposed financial instruments or services before recommending any suitable financial services and instruments (suitability test). When financial services providers offer financial services other than portfolio management and investment advice, they must enquire about the clients' knowledge and experience in relation to the proposed products or services and must ensure, before providing the products or services, that they are appropriate for the clients concerned

(appropriateness test). Financial services providers are under no obligation to assess appropriateness if their services consist solely in managing an account or security account, or the execution or transmission of client orders (execution-only services). Nevertheless, the Swiss government may further restrict this exception through an ordinance in line with the opinion expressed by the Swiss Financial Market Supervisory Authority (FINMA) in 2010, in a position paper on distribution rules which stated that,

‘Financial services providers may only carry out transactions with financial products for a retail client without an appropriateness test if the client instructs the provider to carry out the transaction on their own initiative and the products in question qualify as simple financial products. Simple financial products are readily understandable, do not impose any obligation on the client over and above the acquisition costs, and may be regularly sold on the market or returned to the producer’.¹

If the suitability or appropriateness tests are not met, clients must be warned accordingly before completion of the transaction. If the information received by the financial services provider is not sufficient for assessing the (i) suitability, clients must be informed and no service shall be provided to them; and (ii) appropriateness, clients must be warned that the financial services provider is unable to determine whether the financial services or instruments are appropriate for them. Clients can request execution of the transaction against the opinion of the financial services provider nonetheless, but the financial services provider must document its warning and the subsequent client decision.

The FFSA strives for more transparency and avoidance of conflicts of interests. Financial services providers must keep a written record of the information collected from, and the services provided to, their clients. The latter have the right to obtain copy of the corresponding documentation, which should be produced to them within 30 days from their request. As to retrocessions, financial services providers may accept them only if: (i) they obtain an express waiver from the clients; or (ii) the retrocessions are passed on to clients in full. A waiver is valid only if the type and scope of the retrocessions have been disclosed before providing the financial services or entering into the contract. The waiver must indicate at least

the calculation parameters and the ranges of the retrocessions that may be paid if the exact amount cannot be determined in advance.

To exercise their activity, client advisers must engage in continuing professional education and training and meet certain requirements (professional indemnity insurance, no prohibition from performing a corresponding activity by the FINMA, etc) for registration in a ‘register of client advisers’, which is compulsory to work as a client adviser in Switzerland.

For cross-border financial services in Switzerland, if foreign financial services providers conduct business subject to authorisation for providers established in Switzerland, they must be listed in the register of foreign financial services providers and their client advisers in the register of client advisers. An exception to this rule exists when the cross-border activity in Switzerland is subject to authorisation from the Swiss authorities. In this case, no registration is required but the relevant authorisation must be obtained in the same way as for providers established in Switzerland. In order to be registered, foreign financial services providers must have authorisation for their activity in their home country and their supervision must be deemed equivalent to Swiss standards. They must be covered by a professional indemnity insurance or provide other similar financial guarantees. Moreover, they must agree to provide the FINMA with information on their business activities and relationships in Switzerland. Finally, there must be an agreement between FINMA and the relevant foreign supervisory authority regarding their mutual cooperation and information exchange.

The FFSA also establishes new rules to harmonise the requirements for prospectus. A prospectus must be published where securities for sale or subscription in a public offer in Switzerland are offered or traded on a trading platform. Exceptions to this rule exist for certain types of offers and securities. The Swiss government may also relieve small and medium-sized enterprises from the prospectus requirements. Besides the prospectus, a so-called ‘Key Information Document for Financial Instruments’ must be produced when financial instruments are offered to retail clients. This basic information sheet must be easy to understand and drafted uniformly, irrespective of the type of financial instrument. It must contain information related to the financial

instrument, in particular the producer, type and characteristics, risk/return profile, costs, and authorisations and approvals. The aim of this document is to enable private clients to make informed investment decisions and to facilitate the comparison between various financial instruments.

Clients' procedural rights to take action against the misconduct of their financial services providers are substantially strengthened by the FFSA. Precise rules determine how clients may obtain copies of their account documents. The burden of proof has been reversed in civil proceedings, financial services providers now bearing the burden of proof for meeting their duties as to statutory information and disclosure. To initiate legal proceedings, clients may, as a first step, engage in conciliation proceedings before the Swiss Banking Ombudsman. The financial services providers that are subject to a conciliation request must participate in the proceedings. Clients may elect to conduct proceedings in English, French, German or Italian. The proceedings must be straightforward, fair, quick and inexpensive or free of charge to the clients. The Swiss Banking Ombudsman has no decision-making power but in the absence of any agreement between the parties, it is to publish its own factual and legal assessment of the dispute and make an appropriate proposal for settlement.

Secondly, two alternative options now exist to facilitate the enforcement of claims. Option A establishes a permanent court of arbitration, having the requisite jurisdiction to entertain claims from retail clients against financial services providers. The proceedings must be fair, straightforward, time effective, inexpensive, or free of charge for the retail clients. Retail clients may apply to a court of arbitration only if they have submitted a request for conciliation before the Swiss Banking Ombudsman. Decisions by arbitral tribunals are final and are subject to a limited judicial review before the Swiss Federal Supreme Court. Option B provides for a Procedural Costs Fund financed by compulsory contributions from financial services providers. Retail clients retain the right to have an appropriate portion of their procedural costs for civil suits covered by the Procedural Costs Fund if: (i) they participated in conciliation proceedings before the Swiss Banking Ombudsman; (ii) their claim is not obviously without merits; (iii) the amount at stake is lower than CHF1 million; and (iv)

they are not in an extraordinarily sound financial situation.

Finally, collective redress mechanisms are also proposed. Non-profit organisations, whose articles of association or by-laws are aimed at protecting the interests of retail clients, have the right to file a legal action in their own name against financial services providers in relation to violations of civil-law obligations related to the provision of financial services to clients. Group settlement proceedings for the amicable settlement of disputes in the event of a large number of claimants are planned with an opt-out option for the clients who do not want to be bound by the group settlement.

Financial Institutions Act

Besides the FFSA, the FinIA governs, in a uniform piece of legislation, the supervision of five categories of financial services providers, namely: (i) portfolio asset managers; (ii) qualified asset managers (collective investment schemes and pension funds); (iii) fund management companies (collective investment schemes); (iv) securities firms; and (v) banks. It is worth noting that investment advisers are not subject to supervision as such. Investment advisers are therefore entitled to operate without licence if their activities do not fall de facto within the scope of asset management business.

As a matter of principle, the rules applicable to financial institutions that already operate with a licence under existing laws will be taken over from the applicable laws (Federal Act on Banks and Saving Banks, Federal Act on Collective Investment Schemes, Federal Act on Collective Investment Schemes) without any material changes. The FinIA sets out common provisions related to the licensing regime that is uniformly applicable to all five categories of regulated financial services providers, in particular, the guarantee of irreproachable business conduct, rules on proper internal organisation and the tax compliance of clients' assets. Financial institutions must verify, when accepting assets, whether there is an increased risk that these assets, in violation of tax regulations, have not been taxed or will not be taxed.

An exception to this rule exists and thus verification of tax compliance can be omitted when the client is liable to taxation in a state with which Switzerland has entered into an

agreement for the automatic exchange of information. When financial institutions have reasons to believe that the assets are not tax compliant, they must refuse to enter into any new contractual relationship and must terminate the banking relationship with existing clients if the latter fail to demonstrate that their assets have been duly taxed and that tax regularisation would not expose them to any unacceptable damage. In addition to these common provisions, specific rules apply to each type of financial services provider. Additional requirements (legal form, scope of authorised activities, minimum capital and financial guarantees, etc) exist in light of their differentiated activities.

The FINMA is the body responsible for the supervision of regulated financial services providers, namely qualified asset managers, fund management companies, securities firms and banks. As for the supervision of portfolio asset managers, defined as persons mandated to manage assets on a commercial basis in the name of and on behalf of clients, there are two options: supervision by the FINMA or by a supervisory organisation based on a model similar to the Financial Industry Regulatory Authority (FINRA). Portfolio asset managers may benefit from a grandfathering clause allowing them to continue their activity without any licence if they have performed their activity for at least 15 years at the time of the FinIA entering into force and provided they do not accept any new clients.

Position of the Swiss government

According to the Swiss government, the FFSA and the FinIA will reinforce the attractiveness of Switzerland in the wealth management sector, which has traditionally been a pillar of the Swiss financial centre. The improved protection of clients strengthens confidence in the Swiss market for wealth management. The best quality services provided renders Switzerland more appealing for existing and new customers, especially in the wake of the financial crisis, where many clients lost confidence in the worldwide financial markets. The FFSA and the FinIA should lead to sustained change in the terms of competition in the wealth management market. They establish comparable conditions for the provision of financial services, reduce conflicts of interest and generate higher regulatory costs. However, the adjustment process should lead to an increase of the average size (measured in terms of customer

assets administered) of active asset managers in the market. A concentration in the asset management market may amount to less intense competition in the long term. The supervision of portfolio asset managers may create new barriers to market entry. To mitigate this risk, the Swiss Government suggests keeping the fees levied for the supervision relatively low.

Position of the Swiss Banking Association

The Swiss Banking Association (SBA) opposes the creation of a register of client advisers as provided in the draft FFSA. The SBA is also fundamentally opposed to the special provisions related to civil procedure between retail clients and financial services providers – in particular, the reversal of the burden of proof, the establishment of the Procedural Costs Fund intended to cover the clients' legal costs, collective action and group settlement deemed to go far beyond what is reasonable (European regulations do not provide for them). As to the FinIA, the SBA welcomes the introduction of the supervision of portfolio asset managers. While the SBA is committed to a tax-compliant financial centre, the SBA stresses that banks in Switzerland already work with their clients to regularise legacy situations and support the introduction of the automatic exchange of information (EAR) with foreign countries. But the SBA rejects the provisions regarding tax compliance. It would be a foreign body in the FinIA, with no equivalent at the international level, thus resulting in disproportionate costs. It may also be impossible to implement, because 'no one can know the tax laws of more than 100 countries'.

Standpoint of the Swiss Association of Asset Managers

According to the Swiss Association of Asset Managers, the draft FFSA and FinIA create bureaucratic hurdles without materially improving investor protection unless one considers that placing clients under wardship qualifies as 'protection'. It also argues that while work places will be preserved in the 20 largest banks in the country, all other financial services providers will pay the price with higher regulation costs without any benefit in return. This association is also opposed to supervision of portfolio asset managers by the FINMA or another

supervisory organisation and advocates for reinforcement of self-regulation.

Conclusion

The FFSA and FinIA proposals are regulatory responses to the financial crisis, in particular the Madoff and Lehman Brothers affairs. In a position paper published in March 2010 after investigating these two cases, the FINMA opined that the applicable legislation did not adequately safeguard investors and called for regulatory action.² The requested legislative changes were laid out in a second FINMA's position paper on distribution rules issued on 24 February 2012, which called for the creation of the FFSA and FinIA.³ The result of the consultation on these bills should prompt hot debates at Parliament in 2015.

It remains to be seen what will remain of the draft FFSA and FinIA, in particular, whether the provisions on

clients' procedural rights will be enacted notwithstanding the wave of protests from market players. While these two new pieces of legislation will bring stricter rules on business conduct and organisation for financial services providers and the distribution of financial products along with higher regulatory costs, they may as well provide clients, but also financial services providers, with more defined rules. In the event of subsequent disputes related to an investment, this should facilitate the allocation of responsibilities, obligations and rights between financial services providers and their clients.

Notes

- 1 www.finma.ch/e/finma/publikationen/Documents/pos-vertriebsregeln-20120224-e.pdf, p 18.
- 2 See www.finma.ch/e/aktuell/pages/mm-lehman-madoff-20100302.aspx.
- 3 www.finma.ch/e/finma/publikationen/Documents/pos-vertriebsregeln-20120224-e.pdf.

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