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The Protection of Financial Investors: The Road to a Collective Redress Mechanism in Switzerland?

by Sandrine Giroud and Marina Joos *

I. Introduction

The current trend is generally towards increased financial investor protection. In line with this development, the Swiss government has recently acknowledged the need to improve investors' protection by way of a Federal Financial Services Act (FFSA) and by working on a more comprehensive and developed regime of collective rights under Swiss law.

At the European level, the European Commission recommended that stricter requirements be specified in the revised Markets in Financial Instruments Directive (MiFID) for portfolio management, investment advice and the offer of complex financial products such as structured products. It also recommended recently that all EU Member States implement general injunctive and compensatory collective redress mechanisms for the enforcement of mass claims resulting from EU legislation, including in particular those related to markets in financial instruments. At the domestic level, many EU countries, such as the Netherlands, already introduced collective redress mechanisms available in particular to financial investors in their legislation.

At the Swiss level, the Swiss government, in surveys published recently on collective redress and also on financial services [1], acknowledged the general need to increase the procedural protection of financial investors, including by way of the exercise of collective rights such as where a large number of financial investors in the wealth management sector have incurred losses due to the same damaging event. In addition, the Swiss government identified shortcomings in the protection of financial investors in substantive law terms [2]. This follows, in particular, the large scale investigations conducted by FINMA (the Swiss Financial Market Supervisory Authority) in 2009 on the Lehman Brothers bankruptcy case — relating to the distribution of structured products which were guaranteed by subsidiaries of Lehman Brothers Holdings Inc. and which, thereafter, became bankrupt — and the Madoff fraud case [3].

Against this background, the Swiss government wishes to procure better and uniform protection to financial investors, through the enactment of the FFSA, [4] as well as a general collective redress mechanism available in particular to financial investors in cases of mass or group claims. [5]

After briefly outlining the current legal framework available to financial investors in Switzerland and its substantive as well as procedural shortcomings, we will examine the measures which Switzerland intends to enact through the adoption of the FFSA and the introduction of general collective redress mechanisms.

II. The Current Legal Framework in Switzerland

A. Shortcomings in Substantive Law

Swiss law does not provide for uniform rules for the distribution of financial products to either institutional or retail investors. In particular, different rules of conduct apply depending on the type of financial services provider or banking relationship involved (e.g., execution-only, investment advisory or portfolio management). For instance, in an execution-only relationship, clients as a rule are entitled to be informed only as regards to the generic risks associated with the envisaged transaction, while in an investment advisory relationship, the bank in particular must inform the client as to the specific risks incurred in relation to a specific transaction, whilst taking into account the client's financial knowledge and expertise.

In the aftermath of the financial crisis, FINMA identified the need for better legal and regulatory protection of financial investors following the conclusion of its investigations on the Madoff and Lehman Brothers cases. In particular, FINMA found that current regulations do not provide sufficient remedies to the existing imbalance between financial services providers and clients, mainly due to significant information asymmetries. For instance, in cases related to the Lehman Brothers bankruptcy, FINMA considered that the risk of loss associated with the purchase of the financial products concerned had not been explained in sufficiently simple and comprehensive terms. In particular, the explanatory documentation prepared by the banks potentially gave clients the false impression that the counterparty risk was incurred vis-à-vis the distributor — as opposed to the issuer — of the financial product. To remedy these shortcomings, FINMA suggested that uniform rules of conduct — similar to the MiFID rules — be applicable to financial services providers. In particular, two main areas were identified as requiring action: (i) the information provided to the investor, in particular on the return potential and the risk of loss associated with the purchase of financial products; and (ii) the creation of a client risk profile to ensure in particular adequate risk diversification in the wealth management business.

B. Shortcomings in Procedural Law

Since the beginning of the 2008 financial crisis, the inability of investors to efficiently join forces under current Swiss procedural law and the resulting issues were raised not only by consumer protection associations and legal scholars, but also by Swiss members of Parliament. In particular, in the Lehman Brothers and Kaupthing bankruptcy cases, one of the main obstacles for financial investors was their inability to bear the necessary court costs and litigation expenses.

Presently, Swiss law does not provide for specific procedural rules for handling mass claims, including for damages suffered by investors on a mass scale and in relation to the acquisition of financial products. So far, the Swiss legislator has in particular refused to introduce a collective action similar to the US "class action", mainly due to socio-political reasons and cultural considerations. When revisiting this question in the context of elaborating the 2011 Swiss Code of Civil Procedure (SCCP), [6] such a procedural tool was specifically rejected for it was deemed contrary to European legal tradition and, in particular, to each party's right to freely dispose of its rights, which is a central pillar of Swiss law.

Therefore, and to deal with mass claims, Swiss courts must rely on the existing procedural tools for dealing with multi-party proceedings. Such procedural tools comprise the following: (i) the simple joinder of parties; (ii) the representative action; (iii) special collective actions; and (iv) certain special procedural powers entrusted to courts, which are briefly described below.

The simple joinder – In the event several persons hold claims based on a similar set of facts or similar legal grounds, their collective interests are primarily protected by the simple joinder mechanism (Article 71 SCCP). [7]

The simple joinder enables a plurality of claimants to initiate judicial proceedings jointly. Yet, each joint claimant remains a separate party to the proceedings and may proceed independently. Furthermore, claimants may only be joined to the proceedings wilfully and there is no obligation for the court to inform potential claimants of the initiation of the proceedings. Moreover, the resulting judgment may differ for each joint claimant and is only binding upon the parties to the proceedings.

There is also no favourable treatment in terms of cost determination and allocation. Court costs must be paid in advance by the claimants and are generally calculated based on the total amount in dispute. Moreover, unless strict requirements are met, the claimants must bear all necessary expenses, which comprise in particular attorneys' fees. Contingency fee arrangements are not permitted under Swiss law. In addition, in Switzerland, the "loser pays all" rule is applicable. Thus, before initiating proceedings, a claimant will not only have to assess the risk of losing the case and not obtaining redress, but also of having to pay, at the end of the day, all court costs and litigation expenses, which comprise in particular the defendant's attorneys' fees.

The representative action – In certain circumstances, collective interests can further be safeguarded by way of a representative action, meaning a collective action brought by a representative body pursuant to Article 89 SCCP. Such action, however, may only be brought by a pre-existing association or organisation of national or regional importance, the bylaws of which expressly provide for the safeguarding of the economic interests of the concerned group of individuals. Furthermore, a representative action may only be initiated to protect the personality rights of the members of the group, by way of an injunctive or, alternatively, declaratory relief and thus excludes monetary claims.

Other collective actions – Several federal statutes expressly reserve the possibility of initiating collective actions, be it through a representative body or an individual. However, the scope of application of such collective actions is limited to specific areas of the law.

For instance, the Federal Act against Unfair Competition, the Federal Trademark Act, the Federal Gender Equality Act as well as the Federal Workers' Participation Act provide for collective actions to be brought by representative bodies. These collective actions are, to a large extent, similar to the representative action provided for under Article 89 SCCP. In particular, only injunctive or declaratory relief may be sought by such representative bodies. However, by contrast, representative bodies are authorised to seek the protection of rights other than personality rights of the members of the group.

Furthermore, the possibility of initiating a collective action through an individual is provided for under the Federal Collective Investment Schemes Act (CISA) and the Federal Swiss Merger Act (SMA). Under the CISA, for instance, a judicially appointed representative may initiate a collective action and seek monetary redress on behalf of the affected investors where funds have been unlawfully diverted and/or drawn upon at the expense of a contractual collective investment fund (Article 86 CISA). Pursuant to Article 86(4) CISA, the resulting judgment is binding on all affected investors, irrespective of their agreement to participate to the collective judicial proceedings.

Court Procedural Powers – Swiss courts are entrusted with certain procedural powers to enable a simplification of the proceedings. In order to deal with several claims which have a similar subject matter, courts may (i) order the joinder of separately filed claims (Article 125(c) SCCP); (ii) stay the proceedings, in particular in the event the decision depends on the outcome of other pending proceedings (Article 126 SCCP); or (iii) refer the legal action to another court before which a related legal action is pending (Article 127 SCCP).

In sum, Swiss law does not provide for adequate procedural tools for dealing with mass claims, including damages suffered by financial investors on a mass scale and in relation to the acquisition of financial products. Indeed, the simple joinder does not allow for a simplification of the proceedings, or a more favourable allocation of litigation costs, thus failing to ensure effective enforcement of potential mass investor claims. Furthermore, the general representative action is limited to the protection of the personality rights of group members and excludes monetary claims. Access to the general representative action is further limited to specific representative organisations. Claimants are not allowed to create, after the facts, *ad hoc* associations or organisations to bring a collective claim. Moreover, even though certain federal statutes allow for monetary redress by way of a collective action — resulting in a judgment with a binding effect on all affected parties — the scope of application of such collective action is very limited and of no help to financial investors seeking redress. Lastly, the courts are not entrusted with the necessary procedural powers to simplify proceedings in cases of mass claims.

The shortcomings of current Swiss procedural law in cases of mass or group claims, including in the financial markets sector, were recently acknowledged by the Swiss government. Indeed, in its recent survey on collective redress, [8] the Swiss government states that the existing procedural tools are insufficient and inadequate to efficiently deal with mass or group monetary claims. Furthermore, the Swiss government identifies the current rules on determination and allocation of litigation costs as being particularly problematic from the point of view of effective access to justice in cases of mass or group claims, in particular where the separate individual claims are relatively small.

III. Current Developments of Investor Protection in Switzerland

In an attempt to remedy the existing shortcomings in financial investor protection, the Swiss government plans to procure increased uniform substantive law protection to financial investors in the wealth management sector through the enactment of a Federal Financial Services Act (FFSA) [9], as well as a general collective redress mechanism available in particular to such financial investors. [10]

In substantive terms, the Swiss government recommends in particular: (i) the harmonisation of regulations applicable to financial services, meaning that similar financial products be subject to the same requirements within Switzerland, irrespective of the financial services provider in question; (ii) increased transparency regarding financial products distributed in Switzerland, in particular vis-à-vis private investors whereby financial services providers should be obliged to publish a prospectus for any and all securities offered in or from Switzerland, as well as key investor documents for complex financial products; and (iii) tightening the rules of conduct applicable to financial services providers, in particular imposing a duty on them prior to the execution of a transaction to inform investors on the financial services and products offered – including their appropriateness and suitability – taking into account the investor's experience and knowledge.

In addition, regarding procedural rights, the Swiss government envisagesvarious possible legislative measures to facilitate access to justice in cases of mass or group claims.

Improvement of existing procedural tools. Firstly, the implementation of a general collective redress mechanism could take place by way of an improvement of the existing procedural tools. One of the envisaged improvements is the enactment of adequate rules for the determination and allocation of judicial costs and expenses applicable in particular in case of a simple joinder involving numerous plaintiffs (Article 71 SCCP). Another improvement could be extending the material and functional scope of application of the representative action of Article 89 SCCP to allow for compensation to be claimed by an organisation for violations other than of personality rights of the members of the group.

Introduction of general collective redress mechanisms. A second alternative could be the introduction of a general collective redress mechanism, similar to those existing in other jurisdictions. One of the examined possibilities is the introduction of a test case mechanism similar to German "Kapitalanlager-Musterverfahren" provided for under the "Kapitalanleger – Musterverfahrensgesetz" (KapMuG). [11]

Moreover, and as a ground-breaking procedural novelty, the Swiss government also considers the introduction of a collective action in Switzerland. The envisaged collective action departs to a large extent from the US "class action", which is specifically rejected. Many of the US class action components, such as punitive damages, discovery proceedings, or contingency fees, are considered foreign with the Swiss – and more generally European – legal tradition. Along the same lines as the European Commission's recommendations, the Swiss government recommends the adoption of an opt-in mechanism, together with the enactment of adequate rules concerning the funding of proceedings. In particular, it is suggested that the current rules be amended and simplified in respect of the advance on costs requested by courts at the outset of proceedings, the determination and allocation of judicial costs and expenses, and the funding of proceedings. The introduction of contingency fees is however specifically rejected.

That said, the Swiss government specifies, in its survey on financial services, [12] recourse to class action proceedings could be adequate for financial investors in the wealth management sector in case of "structural breaches of duty", such as the provision of erroneous information in a prospectus or a systematic breach of duty by an investment advisor vis-à-vis the client pursuant to the instructions of his supervisor. Moreover, the need for such a collective redress mechanism is rejected when it comes down to an individual case. Such is the case for instance "where erroneous advice has been given."

Lastly, the implementation of a collective settlement mechanism similar to the Dutch collective settlement mechanism provided for under the Dutch Act on the Collective Settlement of Mass Damage Claims, otherwise known as WCAM, [13] is envisaged. The Swiss government indicates recourse to such collective settlement proceedings should however be limited to very specific situations, mainly cross-border mass harm situations. Moreover, it is suggested that adequate rules on the determination and allocation of the judicial costs and expenses be implemented.

IV. Conclusion

In the aftermath of the 2008 financial crisis, the Swiss government identified shortcomings in the protection of financial investors, both in substantive and procedural terms. The Swiss government found in particular that current regulations do not adequately remedy the imbalance existing between Swiss financial centres' actors, which is mainly due to information asymmetries between financial investors on the one hand and financial services providers on the other. In cases of mass claims, the Swiss government identified an additional imbalance relating to the inability of investors, who have incurred losses due to the acquisition of a financial product, to efficiently join forces and have access to justice.

The legislative measures proposed by the Swiss government, in particular the introduction of a collective redress mechanism, fall in line with the developments taking place internationally, notably at the EU level. As stated by the Swiss government, increasing the efficiency of collective rights would not only guarantee a better access to justice, but would also improve the good functioning of courts when faced with collective damages and would eventually promote the competitiveness of Switzerland as a jurisdiction.

However, the introduction of a collective redress mechanism would be a revolution for the Swiss legal system. Indeed, the implementation of such a procedural tool would open a Pandora's box and many legal questions would have to be solved, amongst others the issue of notification to the persons concerned or the compensation to be granted to victims, including the method of allocating such compensation amongst victims. Moreover, banks and other financial institutions already expressed reservations towards the implementation of the FFSA. The debate is expected to be animated. Yet, it appears that the trend in Switzerland nonetheless will go towards an increased protection of financial investors including by way of collective rights.

1 Report of the Swiss government, "Exercice collectif des droits en Suisse: état des lieux et perspectives" (3 July 2013, available at: http://www.ejpd.admin.ch/content/dam/data/pressemitteilung/2013/2013-07-03/ber-br-f.pdf (last visited 10 July 2013); Swiss Federal Department of Finance hearing report "Financial Services Act (FFSA): Key thrusts of potential regulation" of 18 February 2013, available at: www.efd.admin.ch/dokumentation/zahlen/00578/02686/index.html?lang=en (5 June 2013).

2 Swiss Federal Department of Finance hearing report "Financial Services Act (FFSA): Key thrusts of potential regulation" of 18 February 2013, available at: www.efd.admin.ch/dokumentation/zahlen/00578/02686/index.html?lang=en (5 June 2013).

3 FINMA report "Madoff fraud and distribution of Lehman products: implications for investment advisory and asset management business" of 2 March 2010, available at: www.finma.ch/e/aktuell/pages/mm-lehman-madoff-20100302.aspx (5 June 2013). Also see, FINMA report "Key points: FINMA Distribution Report 2010" of 10 November 2010, available at: www.finma.ch/e/aktuell/pages/mm-diskussionspapier-vertriebsbericht-20101110.aspx (5 June 2013).

4 ; Swiss Federal Department of Finance hearing report "Financial Services Act (FFSA): Key thrusts of potential regulation" of 18 February 2013, available at: www.efd.admin.ch/dokumentation/zahlen/00578/02686/index.html?lang=en (5 June 2013).

5 Report of the Swiss government, "Exercice collectif des droits en Suisse: état des lieux et perspectives" (3 July 2013, available at: http://www.ejpd.admin.ch/content/dam/data/pressemitteilung/2013/2013-07-03/ber-br-f.pdf (last visited 10 July 2013).

6 The SCCP entered into force on 1 January 2011.

[7] In French “consorité simple”; in German “einfache Streitgenossenschaft”.

[8] Report of the Swiss government, “Exercice collectif des droits en Suisse: état des lieux et perspectives” (3 July 2013, available at: http://www.ejpd.admin.ch/content/dam/data/pressemitteilung/2013/2013-07-03/ber-br-f.pdf (last visited 10 July 2013).

[9] Swiss Federal Department of Finance hearing report “Financial Services Act (FFSA): Key thrusts of potential regulation” of 18 February 2013, available at: www.efd.admin.ch/dokumentation/zahlen/00578/02686/index.html?lang=en (5 June 2013).

[10] Report of the Swiss government, “Exercice collectif des droits en Suisse: état des lieux et perspectives” (3 July 2013, available at: http://www.ejpd.admin.ch/content/dam/data/pressemitteilung/2013/2013-07-03/ber-br-f.pdf (last visited 10 July 2013)

[11] “Kapitalanleger-Musterverfahrensgesetz” of 19 October 2012 (BGBl. I S. 2182), lastly amended as per Article 3 of the Federal Statutes dated 4 July 2013 (BGBl. I S. 1981).

[12] Report of the Swiss government, “Exercice collectif des droits en Suisse: état des lieux et perspectives” (3 July 2013, available at: http://www.ejpd.admin.ch/content/dam/data/pressemitteilung/2013/2013-07-03/ber-br-f.pdf (last visited 10 July 2013) ; Swiss Federal Department of Finance hearing report “Financial Services Act (FFSA): Key thrusts of potential regulation” of 18 February 2013, available at: www.efd.admin.ch/dokumentation/zahlen/00578/02686/index.html?lang=en (5 June 2013).

[13] The WCAM is laid down in Articles 907-910 of Book 7 of the Dutch Civil Code and Article 1013 of the Dutch Code of Civil Procedure or Wetboek van Burgerlijke Rechtsvordering. The WCAM entered into force on 27 July 2005.

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