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New rules for the Swiss financial centre – FFSA and FINIA

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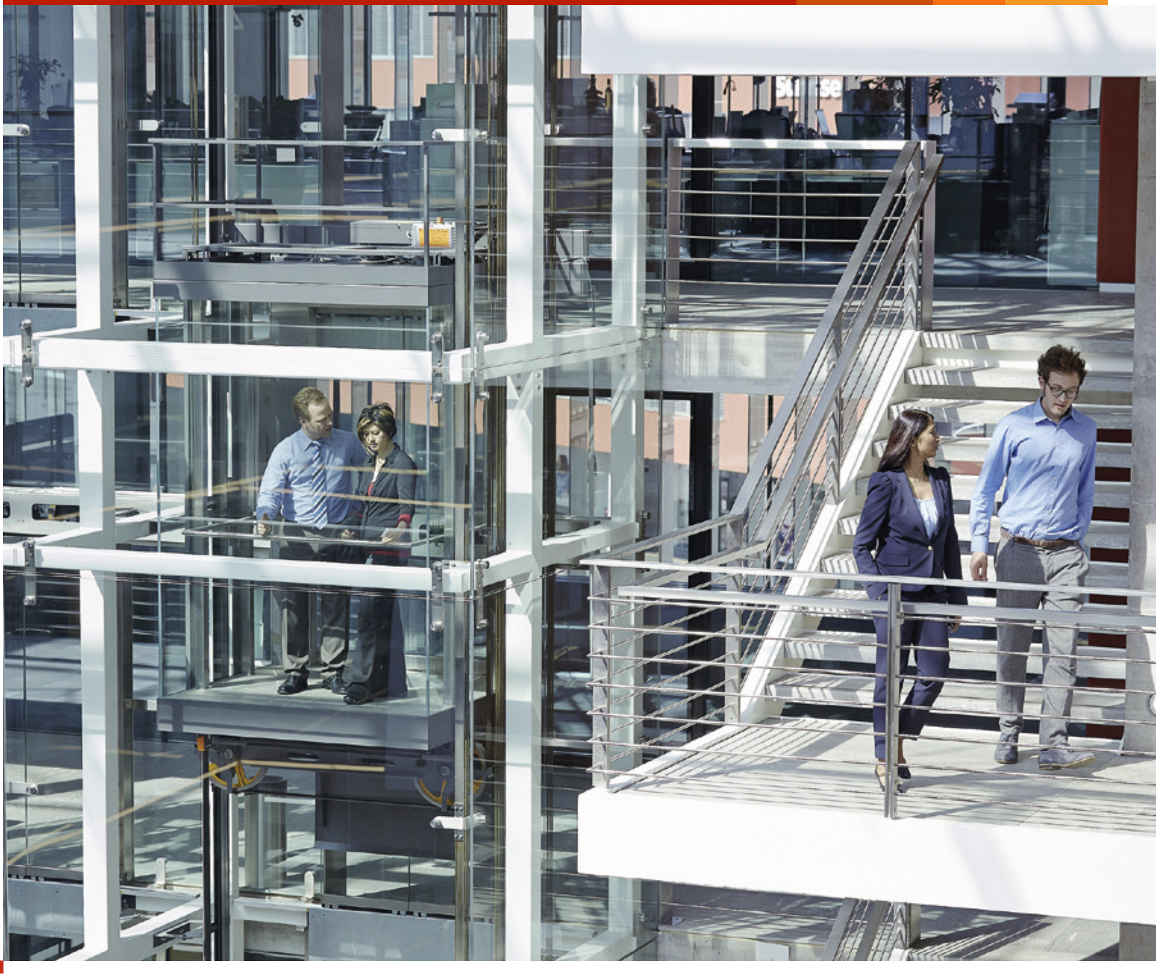

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Background

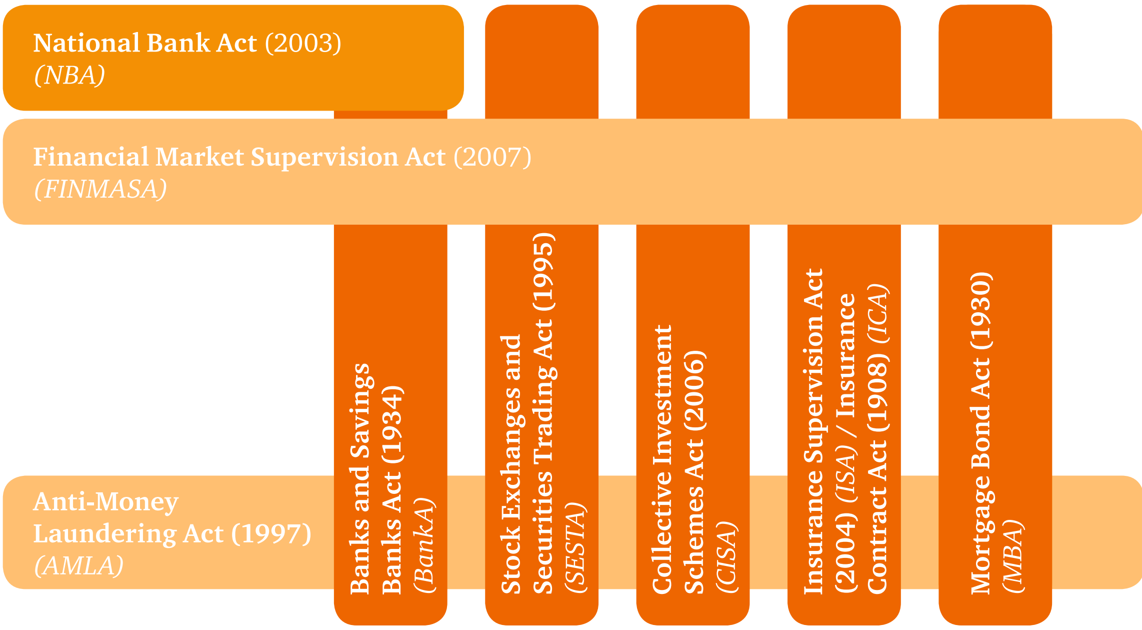
In recent years, regulation has become a key strategic consideration for financial intermediaries in an increasingly networked world. The complexity and interconnectivity of the various regulatory initiatives are constantly on the rise, whilst the related requirements and costs that market participants need to deal with are also increasing, even as their strategic manoeuvring room continues to shrink.

In the wake of the recent financial crisis, the European Union (EU) and the United States of America have been the de facto drum majors in the global march towards more forceful rules of the game and the establishment of binding standards for the international financial markets – and the cadence of those regulatory initiatives is picking up steadily. Although not part of the harmonised EU market, Switzerland has also not been able to turn its back on these developments. Although it managed to sidestep one-to-one transposition of the EU's Markets in Financial Instruments Directive (MiFID), which took effect throughout the EU in 2007, the Confederation has since then taken the route of aligning its own rules and regulations with EU standards. The main intent in doing so was to heighten investor protection and lay the groundwork that would enable Swiss financial intermediaries to access the EU market as third-country providers on the basis of "recognised regulatory equivalence".

Initially, the regulation of relevance to the retail fund business – the Undertakings for Collective Investment in Transferable Securities Directive (UCITS) – was transposed in its third and fourth amended versions into Switzerland's Collective Investment Schemes Act (CISA), as were the core elements of the EU's Alternative Investment Fund Managers Directive (better known as the AIFMD). All of these measures were possible without effectively calling into question the decades-long, principles-based Swiss approach to financial market regulation, with its various and generally need-consistent special laws that are tailored to specific sectors. In order to incorporate into Swiss law the next major EU initiatives – namely the European Market Infrastructure Regulation (EMIR) and the revised version of MiFID (i.e. MiFID II) – policymakers in Bern have decided to reconceptualise the regulatory framework for the Swiss financial centre. The key elements of EMIR are to be transposed into a new Financial Market Infrastructure Act (FMIA or Finanzmarktinfrastrukturgesetz, FinfraG) and those of MiFID II into another new law, the Federal Financial Services Act (FFSA or Finanzdienstleistungsgesetz, FIDLEG). In addition, a new Financial Institutions Act (FINIA or Finanzinstitutsgesetz, FINIG) will govern the sector-overarching licensing requirements and other organisational preconditions for financial institutions in Switzerland.

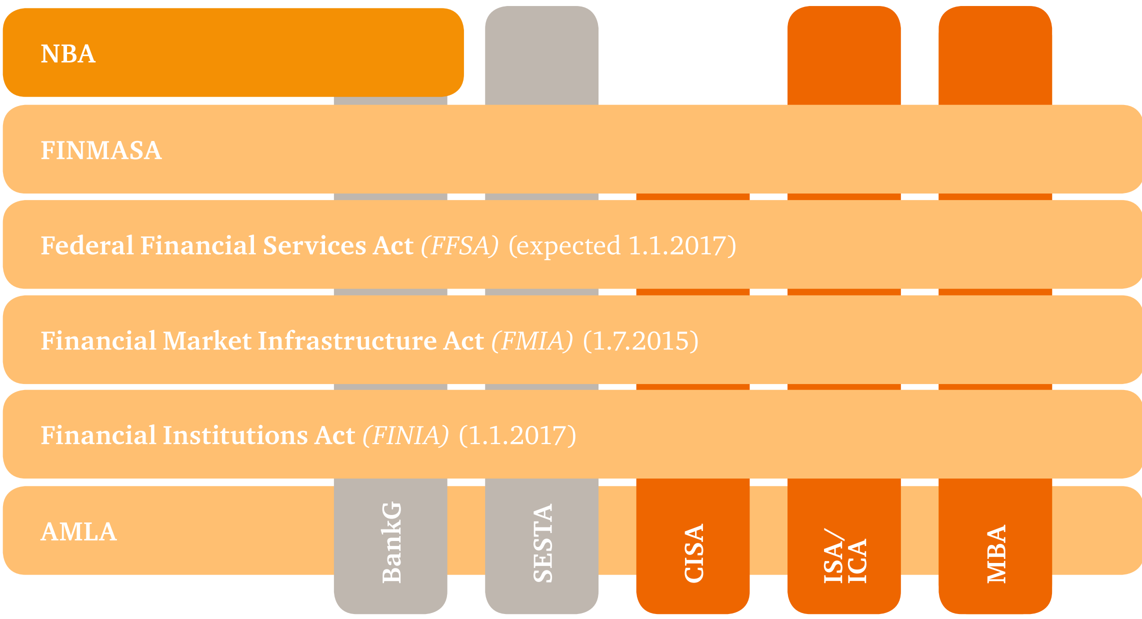
On 13 December 2013, the Federal Council launched the consultation period for FMIA, which ended on 31 March 2014. On 27 June 2014, it then commenced consultation on FFSA and FINIA, which will last until 17 October 2014. Viewed as a whole, these initiatives constitute a departure from Switzerland's traditional pillar-based model for financial market regulation (see Figure 1) in favour of what conceptually is a modular system built at various regulatory levels. As a part of this, especially the standardisation provisions regarding the regulation of financial institutions that were previously covered by the Banking Act (BankA), the Securities Exchange Act (SESTA) and CISA will be integrated into the new laws.

Figure 1: Current Swiss financial markets regulation framework



Because prudential supervision will be broadly expanded and intensified for areas that were previously supervised only indirectly via self-regulation (see Figure 3) and simultaneously the implementation of rules conceived by the EU will presumably have a substantial influence on the traditional business models of practically all types of Swiss financial intermediaries, it is strongly recommended that these new regulatory initiatives be addressed in a timely manner. Below, we offer you an initial overview of the most significant new aspects of the two financial market laws now under consultation (hereinafter, D-FFSA and D-FINIA).

Figure 2: Future Swiss financial markets regulation framework

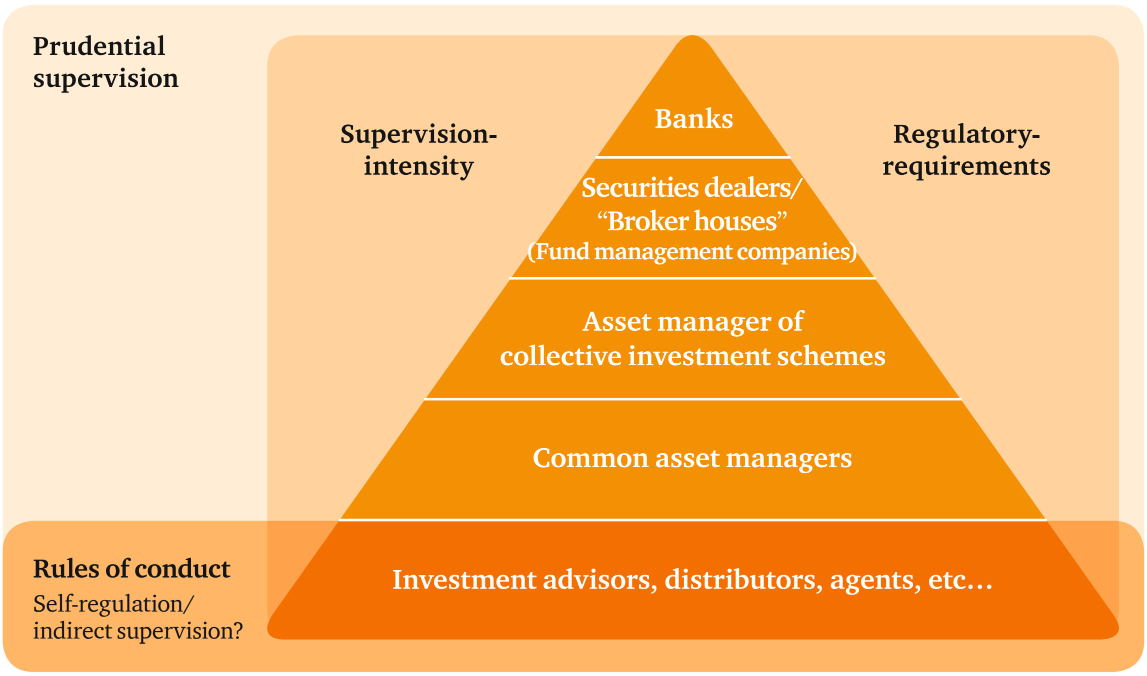


Financial Institutions Act (FINIA)

The purpose of FINIA is to regulate uniformly the supervision of all financial services providers that conduct asset management activities of any nature. For competitive reasons as well as out of consideration for the regulatory divide between Switzerland and its neighbouring countries, the topic of asset manager supervision has been under discussion for years not just in expert panels and by means of parliamentary initiatives, but also in academia. D-FINIA now proposes the inclusion of asset managers in the planned "license cascade". The introduction of prudential, comprehensive supervision of independent asset managers has to be considered the most significant change that FINIG will bring to the Swiss financial center.

In Art. 5 D-FINIA, a straightforward hierarchy of the specific licensing statuses is introduced. A licence associated with more extensive requirements automatically constitutes permission to also perform the activities of lower-level licences. This means that, as opposed to today, a bank will no longer need to have an additional securities dealer licence (or as it will be called in future, as "Wertpapierhaus ". presumably brokerage house or broker-dealer) if it also conducts trading on behalf of clients or carries out other activities of a securities dealer. Not included in the license cascade is the fund management company. The rationale here is on one hand the very specialised activity of a fund management company and, on the other, mainly the fact that a fund manager's activities have to be segregated from the banking activitiy or a securities dealer business.

Figure 3: Broadening of prudential supervision and the license cascade



However, exemption from the licensing obligation within the scope of the authorisation cascade does not free one from fulfilling the requirements associated with the additionally performed activities. The only difference is that verification of compliance with those requirements will no longer take place as a time-consuming part of the initial authorisation process, but instead only after the actual activities have commenced (in connection with the annual supervisory audit). The audit firm takes the activities into consideration as part of its risk analysis and annual audit programme (see in this regard the provisions of FINMA-circ. 13/3 “Auditing”).

Figure 4: E-FINIG is subdivided into the following sections

Article	Content	Origin	Significant new aspects
1–3	Substance and scope of applicability	–	Group parent companies and significant group subsidiary companies as per new Art. 2bis BankA (introduced via FMIA)
4–16	Common provisions for all financial institutions	Requirements for prudentially supervised institutions as per BankA, SESTA, CISA	Compulsory tax compliance of the assets
17–20	"Common" asset managers	–	Completely new regulation
21–27	Qualified asset managers	Definition and requirements for managers of collective investment schemes as per CISA	–
28–37	Fund management companies	Definition and requirements for fund management companies as per CISA	–
38–41	"Wertpapierhäuser"	Definition as per SESTA	Renaming to "Wertpapierhaus" (alignment with the internationally accepted designations of brokerage house or broker-dealer)
42–51	Banks	The designation and fundamental requirements for banks, as well as specific requirements for systemically-relevant banks as per BankA	–
52–72	Requirements for banks and "Wertpapierhäuser" as well as financial groups	Requirements as per BankA and SESTA	–
73–81	Branches and representative offices	Authorisation requirements for branches and representative offices as per BankA and SESTA	Possibility of exemption from the licening requirements on the basis of intergovernmental treaties
82–86	Supervision of financial institutions	Supervision as per FINMASA, BankA, SESTA and CISA	Variation for the supervision of independent asset managers by a separate supervisory organisation
87–115	Measures in the event of insolvency	Provisions as per BankA	–
116–117	Dormant assets	Recently adopted rules as per BankA	–
118	Responsibility	Rules relating to responsibility with exculpatory evidence, as already provided for in Art. 145 CISA	Extended to apply to all financial institutions
119–122	Penal provisions	Same as in the previous laws	–
123–126	Concluding provisions	–	Transition phases as well as the abrogation of BankA and SESTA

Requirements for financial institutions

The license cascade also involves an increase in the intensity of supervision and the regulatory requirements, the higher the relevant licencing level is. This corresponds to the current provisions and practice of the Swiss Financial Market Supervisory Authority (FINMA) with regard to banks, securities dealers and other prudentially regulated financial institutions. But through the consolidation into a single law, existing materially unjustifiable differences will be eliminated. An example of this is the treatment of the authorisation and reporting requirements upon changes at licenced financial institutions, where until now considerable differences have existed between the older and newer laws (e.g. BankA vs. CISA).

For several years, the asset management industry has been occupied with the topic of tax compliance in terms of the assets under management. Until now, no explicit regulation has existed in this regard and the issue was highlighted only in a FINMA position paper, which merely referred to the general requirements of compliance and risk management. Also a revision of the Act on Combating Money Laundering and Terrorist Financing in the Financial Sector (AMLA) with the inclusion of tax violation as a predicate offence to money laundering is currently under discussion. The introduction of an explicit, legally binding “white money strategy”, which provides for the duty to assess prior to the acceptance of assets whether there is a risk that the money involved has not been properly reported for tax purposes is proposed in Art. 11 D-FINIA. In our opinion, this would extend clearly beyond the call for changing AMLA and not only include tax offences under certain circumstances. Equally spoken, the draft legislation also takes into account developments at the international level as well as a reduction of the risks in this area that could arise from treaties on the automatic exchange of information (e.g. the OECD Common Reporting Standard). According to the consultation report dated 25 June 2014, the entry into force of this provision is to be aligned with the adoption of automatic information exchange. This appears reasonable, especially in view of the time and effort involved for financial institutions to implement such a new requirement.

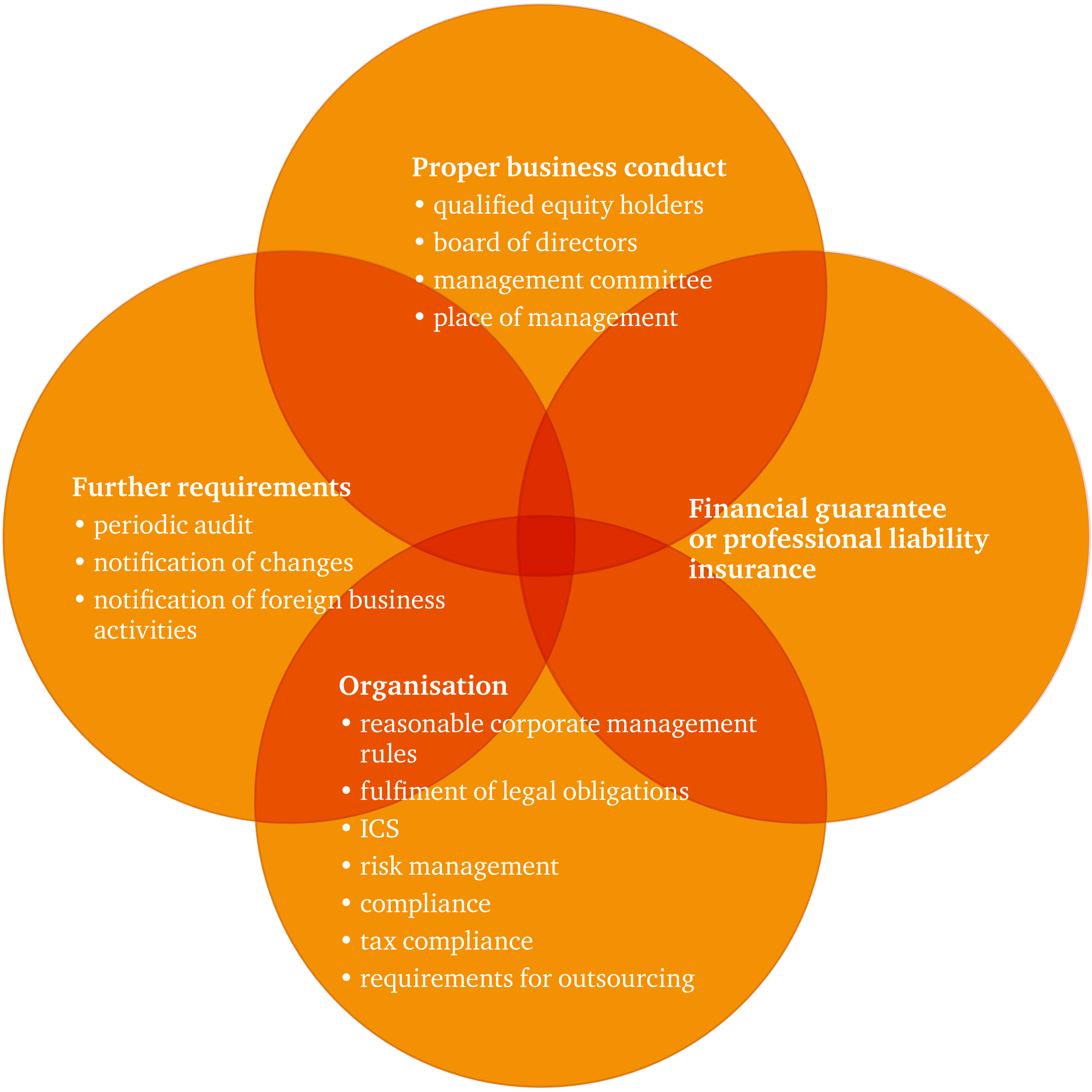
Independent or common asset managers

Subject to the new licencing obligation for asset managers are those who “based on an agreement, professionally manage assets on behalf of and for the account of clients or in some other way can dispose of the assets of clients” (Art. 17 D-FINIA). An asset manager may undertake in particular the management of individual portfolios, provide investment advice, conduct portfolio analyses and distribute financial instruments (Art. 19 D-FINIA).

An asset manager has to to fulfil organisational and regulatory capital requirements and both itself as well as its qualified equity holders and those persons entrusted with management duties must comply with requirements. The related ordinances will have to be awaited for more concrete details on these requirements. As regards the license cascade, it is expected that requirements will be less demanding than for those in the qualified asset manager category. It can be expected that asset managers will need at least to introduce an adequate system of internal controls (ICS), a risk management and compliance function, functional segregation of duties and processes for ensuring tax compliance of clients or investors.

For financial services providers subject to prudential supervision under FINIA, ensuring compliance with the rules is in principle the task of FINMA. However, Art. 82 ff. D-FINIA puts forth for consideration the establishment of a new “supervisory organisation” with a self-regulatory character for asset managers not previously subject to supervision. According to the explanatory letter that accompanies the draft, the assumption is being made that the courts will declare the rules of conduct and organisational obligations under FIDLEG to be civil law standards and that violations of the rules of conduct by financial services providers not supervised under FINIG (e.g. pure investment advisors) can also be subject to criminal sanctions.

Figure 5: Requirements for independent and common asset managers



Various studies have shown that a considerable number of independent asset managers consist of merely one or a small number of individuals and administer assets equivalent to only a few million Swiss francs. Frequently, these are former bank client advisors who have opted to set out on their own. Especially for such small asset managers, the introduction of this new licencing obligation will have significant effects. Without a doubt, fulfilling the supervisory requirements involves higher costs. Will this lead to a forced diminution or the merger of these asset managers, or perhaps an upwards consolidation?

In our opinion, there is considerable potential for mergers in the asset management sector. But in addition to its specified transition phases, D-FINIA provides a significant exception for established asset managers who merely desire to continue servicing their existing clients. According to Art. 125 (3) D-FINIA, independent asset managers who have been in the business for at least 15 years and acquire no new clients will be able to continue their activities without applying for a licence.

Federal Financial Services Act (D-FFSA) (significant new aspects)

More precise definition of the terms "financial services provider" and "financial service" in broadening the authorisation obligation for foreign firms wishing to undertake business activities in Switzerland

Art. 3 D-FFSA defines financial services providers as being all persons who "professionally render financial services to clients in Switzerland", whereas the term "financial service" includes the following activities:

- the purchase or sale of financial instruments;
- the acceptance and transmission of orders that have financial instruments as their substance;
- the administration of assets (asset management);
- the provision of personal recommendations relating to transactions in financial instruments (investment advice);
- the safekeeping of assets for the account of clients;
- the keeping of accounts (i.e. customer deposits); and
- the granting of credits for the execution of transactions in financial instruments.

In contrast to the supervision concepts of most European countries, Swiss supervisory law has until now focused squarely on activities conducted in Switzerland. This affords foreign financial institutions considerable liberties in terms of client acquisition and servicing in Switzerland. Only upon the actual or factual establishment of a presence in Switzerland (e.g. representative office, branch, subsidiary company, etc.) a licence is necessary.

Now, D-FFSA is proposing a duty to register, albeit no ongoing supervision, for foreign financial institutions (Arts. 34–36 D-FFSA). The registration will be contingent on the authorisation by and equivalent supervision of the given foreign country, a professional liability insurance policy or equivalent financial pledge, as well as the obligation to provide information and the existence of a cooperation/information-exchange agreement with the foreign supervisory authority. Also a part of this new requirement is the duty to register client advisors in keeping with Art. 29 D-FFSA.

In our view, this new registration obligation at least partially offsets the competitive disadvantage of Swiss financial institutions in their conduct of international business, and it also enables the supervisory authorities to obtain insight into what until now have been the fully uncontrolled crossborder offerings of foreign financial services into Swiss investors.

New client segmentation systematics

In more overt reliance on MiFID rules, Art. 4 D-FFSA, with its proposed subdivision of clients into the categories of institutional and professional, wealthy private clients and other private clients, brings a new dimension of segmentation that is similar to the opting-in and opting-out systematics of the partially revised CISA. Within these classifications, the latter choice serves to satisfy the greater or lesser individual need for protection. The ultimate classification results in differing information and explanatory obligations on the part of the financial services provider. According to the current proposal, those deemed to be professional clients are supervised financial intermediaries, insurance companies, foreign clients who are subject to equivalent prudential supervision, central banks, public entities with professional treasury operations, retirement benefit schemes with professional treasury operations and companies with professional treasury operations. In determining those deemed to be institutional investors, this catalogue of professional investors will be shortened and exclude retirement benefit schemes or other non-financial companies with professional treasury operations. Those who are not by nature professional clients or, via opting-in, have declared that they do not wish to be considered professional clients are deemed to be private clients are.

Independence and retrocessions

The prerequisites for designation as an independent financial institution are new and derived from the corresponding provisions of MiFID. Art. 9 D-FFSA provides that a sufficient number of financial products are to be taken into consideration (open architecture) and no incentives may be received, or if so, they must be passed on to the clients. While the possibility of internal differentiation between independently and non-independently rendered financial services will remain intact, an institution may only refer to itself as independent if it fulfils the requirements of Art. 9 DFFSA.

An issue that goes hand-in-hand with the question of independence is the receipt of Investments on the part of the financial institution. The Federal Supreme Court's interpretation of mandate law as it applies to the field of asset management, and which has been corroborated a number of times in recent years, will now be legally anchored in Art. 26 D-FFSA. The receipt and retention of incentives is only permissible for financial intermediaries if the clients, in full awareness of the type and amount of the incentives, waive the right to have them passed through. Should that not be the case, the financial services provider is obliged to pass on the incentives to its clients. The proposed provision applies expressly to all financial services as well as to all benefits the financial services provider receives in connection with the rendering of a financial service on behalf of a third party. Here, the term financial service as per Art. 3 lit. d D-FFSA is broadly construed and, among other things, also includes execution-only activities.

Although in terms of banks and securities dealers differentiation is only rarely achieved these days through the claim of independence, for asset managers independence represents a significant competitive factor. Thus a timely analysis of the effects of Art. 9 D-FFSA is an important step for many financial institutions in their efforts to implement the new rules with an eye towards devising a sustainable, future-oriented business model. Moreover, coming up with a retrocession-free business model requires considerable advance headwork.

Denser disclosure, documentation and investigatory/explanatory obligations for financial services providers

Under Art. 10 D-FFSA, asset managers and investment advisors will be obliged in future to conduct a suitability test with regard to their private clients as well as an appropriateness test (Art. 11 FFSA). The former requires the financial services provider to gain an overview of the financial circumstances and investment objectives of the client; the latter, to gain a sense of the client's knowledge and experiences with regard to the financial instruments and services on offer – all of this prior to recommending the financial services and instruments that are most suitable for the client. As to other services than asset management or investment advice, an appropriateness test suffices. In other words, in this instance the financial services provider is merely obliged to determine, prior to rendering any service, the client's degree of knowledge and extent of experience regarding the products/services on offer and to examine whether they are appropriate for the client. In the case of professional clients, Art. 12 D-FFSA specifies that the financial services provider may, unless there are indications to the contrary, go on the assumption that the clients have sufficient knowledge and experience to judge a specific service or product and that they can financially bear the associated investment risks. For institutional clients, D-FFSA provides neither for a suitability nor an appropriateness test. Moreover, under Art. 14 D-FFSA an exemption from the duty to conduct an appropriateness test exists if the services are limited exclusively to the carrying of a cash and/or securities or the execution/transmission of client orders and the given service is rendered at the behest of the client. Nonetheless, even in such cases, the clients must be informed that no suitability or appropriateness test has been conducted prior to the rendering of the financial services.

In cases where the suitability or appropriateness of a financial service or financial instrument is lacking, Art. 13 D-FFSA specifies that the financial services provider must warn the client of that fact prior to execution of the relevant transaction. Also stipulated is that, if the information received by the financial services provider is not sufficient for a suitability test, no investment advice or asset management activity may be performed and the client is to be informed of that circumstance. A warning must also be given if a appropriateness test is impossible to conduct and therefore it cannot be assessed whether a financial service or financial instrument is in fact appropriate for the client.

In another adoption of MiFID standards, Art. 15 seq. D-FFSA states that, going forward, financial services providers must document in writing the services that have been agreed with clients, the information about them that has been gathered, as well as the voiced warnings and rendered services. What's more, asset managers and investment advisors will be obliged to document the specific needs of clients as well as the rationale for each recommendation that leads to the purchase or sale of a financial instrument, and to provide copies of that documentation to their clients.

Art. 16 D-FFSA requires that financial services providers give an account of the services they have rendered. This includes in particular the transactions that have been executed, the composition, valuation and appreciation/depreciation of the portfolio, as well as the costs associated with the those services.

Art. 18 D-FFSA anchors a more precise description of the "best execution" principle for client orders, whereas the details need to be firmed up by the Federal Council.

New educational requirements for client advisors

Art. 28 D-FFSA prescribes that client advisors who are active in Switzerland must have sufficient knowledge of the rules of conduct under this new law as well as the professional know-how necessary for their activities. Art. 29 D-FFSA further stipulates that, in future, only those who are entered in the corresponding (to-be-created) client advisor register may act as client advisors in Switzerland. As to the requirements for such an entry, Art. 30 D-FFSA specifies that proof must be given that a professional liability insurance policy has been concluded or collateral of equal value has been made available, and that association with an ombudsman's office has been established as per Art. 75 D-FFSA. If the client advisor works for a financial services provider, the latter can fulfil these requirements. Also, client advisors must not have an entry in the criminal register for any violation of Art. 119–121 or punishable acts against property as per Art. 137–172ter of the Penal Code, and no prohibition of such activity or professional ban as per FINMASA may exist.

Product-specific documentation obligations

D-FFSAsets out in Art. 37 seq. new provisions specifying that securities – i.e. uniformly issued instruments, rights to value, derivatives and book-entry investments – may in principle only be publicly offered in Switzerland if a prospectus has been drawn up and published in keeping with the relevant FFSA rules. The prospectus must be reviewed by an independent examiner.

Under Art. 42 D-FFSA, the prospectus must include the material information necessary for an investor to arrive at an investment decision, amongst which in particular are details regarding the issuer and the warrantors (i.e. the board of directors, executive committee, auditors and further corporate bodies), its most recent annual financial statements, or if the latter are not yet available then an overview of its assets, liabilities, business situation, significant perspectives, risks and any existing or pending legal disputes. In addition, information must be provided regarding the securities to be publicly offered or admitted to trading on an exchange, namely the associated rights and obligations as well as the risks to investors. And as to the offering itself, the manner/type of placement and the estimated net proceeds of the issue must be indicated. These must be provided either in an official language of Switzerland or in English. And lastly, the prospectus must contain in understandable language a summary of the most significant information.

Art. 58 D-FFSA prescribes that, for financial instruments intended for private investors, a basic information sheet is to be drawn up and provided to investors at no cost prior to their final commitment. Here, financial instruments include not only securities, but under circumstances also units of collective investment schemes and structured products. No obligation to produce a basic information sheet is foreseen with regard to stocks.

Enforcement of claims

A significant element of the new FFSA rules are the various provisions governing the assertion of any client claims against financial institutions. Apart from several possibilities aimed at simplifying the enforcement of such claims, also various means of legal recourse are under discussion.

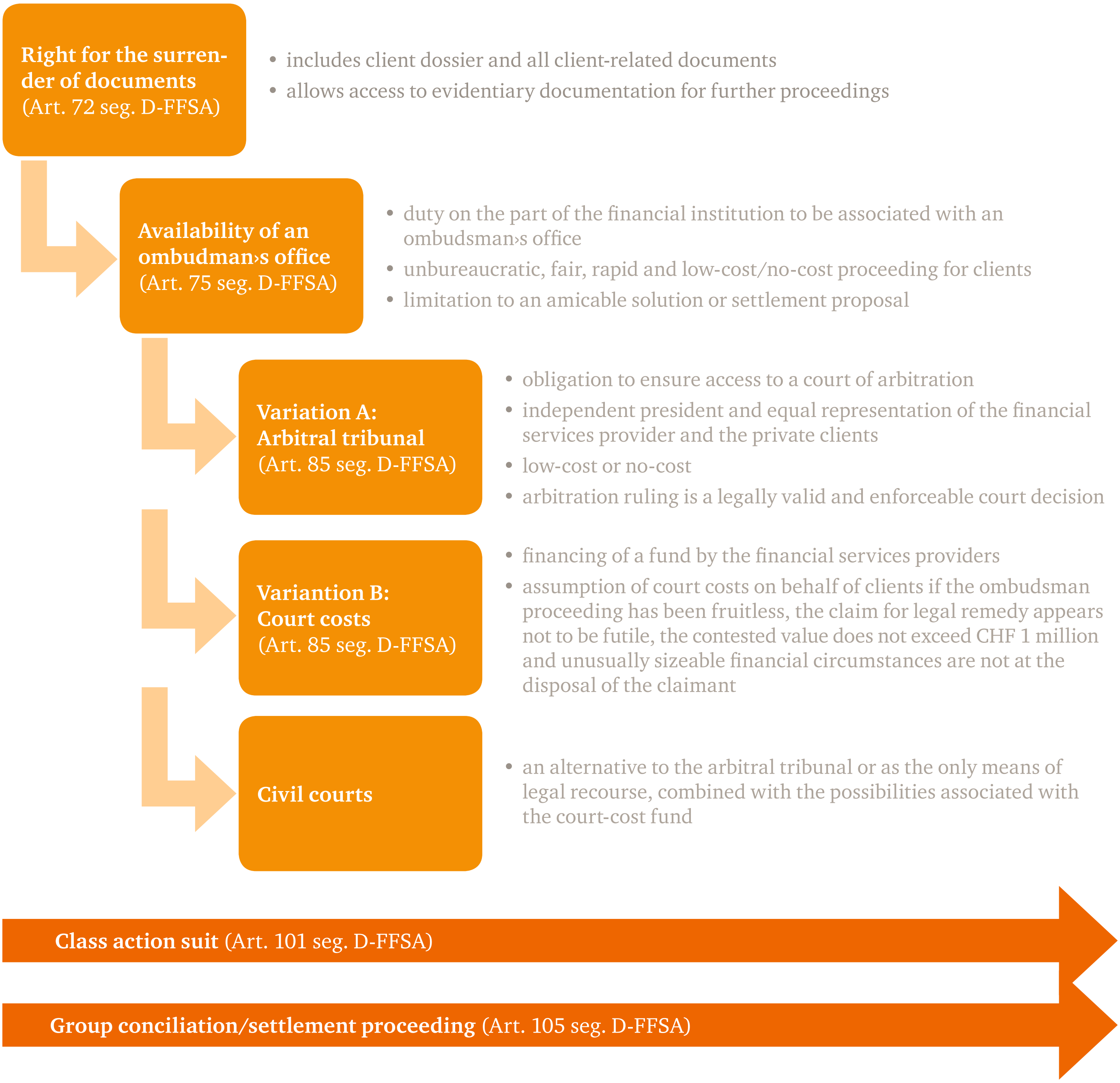
The basis for this comes from the obligation that financial institutions will have to hand over the relevant client files and all client-related documents. This enables – in the event of justified claims – the complainant to have a stronger body of evidence in the various legal proceedings. The obligation to surrender documentation is coupled with a burden of proof reversal in terms of compliance with the information and clarification duties vis-à-vis clients. In other words, in an eventual civil proceeding the financial institution will have to bear the consequences if it cannot prove that it reasonably fulfilled its duties to inform the client. At certain financial institutions, this will make it necessary to establish an extensive compendium of documentation, perhaps involving in certain instances the demand that clients sign the protocols and client profiles.

The ordinary arbitration process, as provided for in civil law, will be supplemented with a specific, financial services ombudsman proceeding. This forms the basis for taking advantage of both types of recourse proposed in D-FFSA. The draft does not foresee any decision-making power on the part of the ombudsman.

For a legally binding decision, two variations are envisaged: a special arbitral tribunal; or the ordinary civil law means of legal recourse combined with trial cost financing. The arbitral tribunal would remain available as an alternative to the ordinary civil court, but in this case without the possibility of privileged, supervisory trial cost financing.

In addition, the rules governing individual legal recourse will be set on a par with two new elements of collective recourse under Swiss financial market supervisory law (the class action suit and a group conciliation/settlement proceeding).

Figure 6: Broadened dimensions of legal recourse



These various elements of legal enforcement lead on one hand to higher costs and, on the other, to a significant change in terms of the legal risks faced by financial institutions. Especially the reversal of the burden of proof as it pertains to compliance with the information obligations will force financial institutions to make major changes in their documentation and advisory processes.

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