Reshaping the future

Rashid Bahar and Thomas Reutter of Bär & Karrer analyse two new bills that seek that to widen the regulation of Swiss financial services

The Swiss government opened a consultation process for the draft bills of a Financial Services Act (Fidleg) and a Financial Institutions Act (Finig). These two projects will reshape the regulatory framework governing the Swiss financial markets. They include new rules of conduct for financial intermediaries, a regulatory regime to prepare a prospectus in connection with public offerings of securities, registration obligations for client advisors and foreign service providers, licensing obligations for asset managers and comprehensive rules aiming to facilitate access to justice.

The consultation process runs until October 15 2014. After that, the Federal Council plans to send the bill of the Financial Services Act and the Financial Institutions Act to parliament in the second quarter of 2015. These two bills are expected to be enacted in the course of 2016 and eventually enter into force on the January 1 2017.

Scope

Whereas under existing regulations, only banks, securities dealers and collective investor schemes (including fund management companies and asset managers for collective investment schemes) are subject to prudential regulation, the draft Fidleg aims to regulate all types of financial services, regardless of whether they are provided by regulated or unregulated entities. Only lending services that are not related to investments and traditional insurance and reinsurance services will remain out of the scope of this draft bill if it becomes law.

Moreover, the draft Fidleg will apply to all types of customers. Going one step further than MIFiD [Markets in Financial Instruments Directive] and following the same classification as under the Collective Investment Schemes Act, it applies to retail clients, professional clients and institutional clients, albeit with a different level of protection and a possibility to opt out or into different levels of protections.

Rules of conduct

The cornerstone of the draft Fidleg is a comprehensive set of rules of conduct. These rules include a duty to inform clients and to ensure that services and products offered are suitable or appropriate for them, and an obligation to ensure best execution. To facilitate the enforcement of the rules of conduct, the draft Fidleg backs the rules of conduct with extensive documentation and reporting duties.

The information duties contemplated by the draft Fidleg aim to give investors a clear picture of what services or products they are getting, in terms of expected risks, returns and costs. Investment advisers and portfolio managers are subject to additional obligations aiming to clarify the scope of their services, namely whether they act independently or not, whether they provide their services on an ongoing basis and whether they analyse the entire market or restrict their investment services to products issued by certain issuer. To facilitate the process, the draft Fidleg provides that these duties can be satisfied in a standardised form in a printed document or on a webpage.

Codifying existing requirements under contract law and taking them one step further, the draft Fidleg contemplates obliging as a regulatory matter investment advisers and investment managers to ensure that the services and instruments they offer are suitable for their clients. Therefore, investment advisers and investment managers will be required to know their clients' financial situation and investment objectives as well as their knowledge and experience and to determine on the basis of this information whether the services and instruments they offer are suitable. All other service providers will be required to ensure that the service or instrument is appropriate for the client.

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As a matter of principle, these obligations will apply across the board. However, the draft Fidleg provides for several exceptions. No appropriateness duty applies when the service provider only custodies securities and carries out orders or when it acts on an execution-only basis at the initiative of the client. The draft Fidleg also allows financial service providers to assume, subject to any contradictory evidence, that professional and institutional investors are aware of the risks they incur and have the financial capability to bear such risks, therefore reducing the burden of the appropriateness and suitability requirements.

Further, the draft Fidleg proposes to expand best execution obligations in line with MiFID II. Moreover, slightly more conservatively, instead of an outright ban, it codifies the principles the Swiss Supreme Court developed regarding inducements and distribution fees as a regulatory obligation applicable to all financial service providers. Namely, a service provider will be required to account and hand over to its clients inducements it receives unless the client waived such right in advance.

The entire system is backed by extensive documentation and reporting obligations as well as duties to take organisational measures. With respect to the latter, they apply both within and outside a given firm. Therefore, in addition to a general obligation to have an appropriate organisation, financial service providers are specifically required to ensure that their employees and any third party they instruct have appropriate qualifications, knowledge and experience to discharge their duties. Within a chain of service providers, the instructing financial institution will be responsible for ensuring that the service providers it retained comply with the rules of conduct, whereas in the other direction, the service provider acting on the instructions of another service provider can assume that the instructing service provider complied with its obligations unless it has any reason to believe that it failed to do so.

Prospectus rules

The draft Fidleg intends to overhaul the prospectus rules. Instead of the existing regime based primarily on private law and the listing rules of stock exchanges, it proposes to introduce a comprehensive regulatory regime governing the content and approval of prospectuses inspired by the EU Prospectus Directive, as amended.

The obligation to prepare a prospectus

under Fidleg will be triggered by any public offering of securities. It will apply both to primary offerings in connection with issuances and secondary offerings. However, the prospectus rules will provide for a certain number of exemptions for offers to institutional investors, to a limited number of retail investors, as well as quantitative limitations regarding exempting offers with a high denomination or minimum investments and a *de minimis* exemption. The prospectus rules also contemplate introducing detailed rules on the content of the prospectus, which will be enforced through an *ex ante* control process, which will no longer be left to self-regulation, but will, instead, be subject to formal administrative proceedings.

Moreover, to ensure that retail investors have sufficient information available, Fidleg envisages obliging producers of investment products, two undefined terms, to prepare a basic information sheet. All investment products except equities, including not only packaged investment products but also straight bonds, will be subject to this regime.

Asset managers and tax compliance

In parallel to the draft Fidleg, the Federal Department of Finance (FDF) has also published a bill for a Federal Act on Financial Institutions (Finig). This will consolidate the existing rules on banks, securities dealers, fund managers and asset managers for investment funds within a single act and expand its scope to all portfolio managers.

The draft Finig aims to put in place a systematic hierarchy of licences from a limited licence for portfolio managers all the way to banking licences at the pinnacle, which allows its holders to carry out any financial service except fund management. Intermediate stages include an asset manager licence, which allows its holder to manage assets of collective investment schemes and pension funds, and a securities house licence, which allows its holder to offer securities custody and trading services.

More specifically, the draft Finig proposes a major development to regulate all portfolio managers. Portfolio managers are not subject to prudential licensing requirements or supervision under the existing regulations. They are only regulated indirectly through the anti-money laundering framework, which is largely delegated to self-regulatory organisations. Although the Swiss Financial Market Supervisory Authority (Finma) has tried to stop the gap through its circular on minimum standards for self-regulation of portfolio management, which imposes a common framework applicable to all professional organisations involved with portfolio management, this regime is very open-textured and allows for substantial differences in terms of enforcement policies.

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This new regime will be similar to the existing regime for asset managers, although in several important areas the requirements will be less stringent. In particular, instead of fully-fledged capital and liquidity requirements, portfolio managers will need to provide appropriate guarantees, a term that needs to be further defined through implementing regulation. Similarly, we expect that the organisational requirements will be less cumbersome, allowing this business to be carried out in a smaller structure than asset managers, securities dealers or banks.

In addition to licensing requirements, the draft Finig also contributes to the Federal Council's so-called white money strategy, which seeks to ensure that Swiss banks manage only tax-compliant funds. It therefore posits an obligation for financial institutions to positively assess whether a given client poses a risk that funds will not be taxed before the initiation of the relationship is accepted. If so, the financial institution will be required to determine whether additional clarifications are necessary based on the specific facts and circumstances. If it concludes that there are any reasons to believe that funds are not or will not be taxed, the financial institution will be required to turn down the client and, with respect to existing clients, close the account unless the client proves that it complied with its tax duties or if a voluntary disclosure would impose an undue burden on the client. Therefore, Finig sets a lower threshold for a financial institution to act than anti-money laundering regulations, which require founded suspicions to trigger the obligation to file a suspicious activity report.

Registration obligations

In addition to licensing obligations in the draft Finig, the draft Fidleg contemplates two registration obligations: one for client advisors and another for foreign financial service providers. These registration obligations do not entail an ongoing oversight, but merely seek to ensure that, at the outset, a client advisor or a foreign financial service provider satisfies the statutory requirements.

Client advisors will need to have appropriate education, including continuing education regarding the rules of conducts. More importantly, client advisors will need to be registered with a newly created registration body to carry out their duty. Registration should be a relatively straight forward process, since client advisors will need to prove that: (a) they were not convicted of any criminal offence under Fidleg or any general financial offence under the Swiss Criminal Code, or subject to a ban from any activity in the financial industry; and (b) that they or their employer has sufficient insurance coverage and is member of an ombuds organisation. Over and above this registration duty, client advisers will also be required to have appropriate training and attend continuing education on rules of conduct.

Foreign service providers, who do not have a permanent physical presence in Switzerland, will, in a departure from the existing regulatory philosophy, be subject to the draft Fidleg and, in particular, be required to register with Finma, if they intend to offer financial services in Switzerland that are subject to licensing requirements (portfolio management, asset managements, fund management, securities trading and banking). In essence, registration should also be available to foreign financial institutions that are licensed and subject to equivalent ongoing supervision in their home country, provided the foreign securities dealer and its home regulator is willing to cooperate and provide information with Finma.

Access to justice

In addition to its regulatory framework, the draft Fidleg provides for a comprehensive set

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of rules aiming to improve access to justice for clients. In particular, the draft Fidleg contemplates the following changes: (i) it intends to impose on financial service providers a strict duty to produce all documents related to a client and their investments at the request of such client; (ii) it shifts the burden of proof in connection with claims for breaches of statutory information and disclosure duties from the plaintiff to the financial service provider; (iii) it institutes a mandatory mediation procedure based on an ombud-system; (iv) it proposes to introduce either a simplified arbitration procedure or a plaintiff fund set up by the government and sponsored by financial service providers that may be tapped by clients in state court litigation against financial service providers; and, (v) in parallel, it also creates a collective action mechanism that allows interest groups to sue on behalf of clients and even to enter into settlement agreements. While all of these changes are game changers, the collective action mechanism is probably the more innovative one and consequently deserves most attention.

The draft Fidleg proposes to allow independent non-profit organisations to act as protectors of the interest of clients. If they satisfy certain general and straightforward requirements (legal personality; operation on a non-profit basis; and, purpose to observe the interest of clients), they can initiate collective actions under Fidleg and tap the plaintiff fund. Fidleg does not set any other specific requirements (for instance, in terms of representativeness) to certify a non-profit organisation as a plaintiff.

Such non-profit plaintiffs cannot under Fidleg sue for damages; they can only seek a declaratory ruling or injunctive relief (for instance, to prevent further breaches). The underlying idea is that, on the basis of this declaratory ruling, individual plaintiffs will be able on an expedited basis to seek damages or any other type of monetary relief. However, in specific cases, a financial institution will be able to object that the plaintiff does not belong to the class (because of specific facts and circumstances) or should not be entitled to damages because, for example, it did not incur any loss or there is no causation between the loss and the breach.

As an alternative to seeking judicial redress, the draft Fidleg allows non-profit organisations to enter into settlements with financial service providers. In such a case, the terms of the settlement may offer individual clients financial compensation, avoiding the two-tiered process of a declaratory ruling followed by an individual suit for damages.

The system sketched out by the draft Fidleg is flawed in several respects. First, it requires the settlement to describe the facts and breaches of law that give rise to the settlement, forcing the defendant to acknowledge having committed wrongdoing. Second, in addition to the certification process which requires the highest cantonal court to review the settlement and ensure that it is fair and compensates the victims of the wrongdoing, it allows individual clients to opt out from the settlement. If more than a third of the victims opt out – a quantum that may be difficult to verify considering that the population of victims may not be known at the outset – either party will be entitled to revoke the settlement. The financial service provider is left with no other choice than litigating the matter individually after going on the record by acknowledging the facts and circumstances as well as the breach of law underlying the settlement. This uncertainty at the end of the process may discourage financial service providers from initiating settlement talks at the outset.

Criminal provisions

To ensure strict compliance with the law, the draft Fidleg proposes to introduce criminal provisions. These provisions relate to breaches of law in connection with prospectuses and basic information documents, illegal offerings of financial instruments and the breach of conduct rules.

The harshest of these provisions relates to disclosure in prospectuses and similar documents. Intentional false information, intentional omission of material information or a failure to include all line items provided by law may lead to imprisonment of up to three years or a fine. The same applies to a failure to provide a prospectus or key investor document in the proper manner or an intentional failure to publish these documents in due course. In a departure from general principles of criminal law, negligence is also sanctioned with a fine of up to 180 daily rates (*Tagessätze* – a fine that is expressed in numbers of days, but which depends on the offender's income).

False information does not have to be material to trigger criminal liability. The same applies for any line item that is required by law to be included in a prospectus or key information document. Neither is it required that one or more investors must have incurred any damage as a result of false or misleading information in the disclosure document. In the case of an intentional act or omission, it seems that the intent must only relate to the false or misleading nature of the information. This is an offence even if there is no further intent to deceive or to obtain a monetary advantage and mere negligence suffices to trigger criminal liability. For instance, a person is exposed to criminal sanctions for merely overlooking of a piece of information in an otherwise properly conducted due diligence review; a conclusion that seems excessively harsh for persons involved in drafting prospectuses.

The draft Fidleg also sanctions certain offerings of financial instruments in breach of the proposed new legal provisions. For example, whoever offers a bond or a structured product to private clients without providing a basic information sheet in accordance with Fidleg will be subject to criminal sanctions, consisting of a fine of up to SFr500,000 ($532,000) in the case of an intentional act, or a fine of up to SFr150,000 in the case of a negligent act.

Further, whoever breaches the duty of information or the duty to conduct an appropriateness or suitability check will become subject to a fine. Theoretically, even a minor omission to inform the client about one line item prescribed by law may lead to a fine. The fines are up to SFr50,000 in the case of an intentional act and up to SFr15,000 in the case of a negligent act.