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April 2014

paragraph issue

Swiss Financial Market Legislation in Transition: Quo vadis?

Probably no other area of law is marked by such a high degree of reform activities at the moment as the area of financial market legislation. On the heels of the conclusion of legislative projects in the banking sector, additional comprehensive regulatory projects are now pending. This "paragraph *issue*" is intended to provide an overview of the current status of the regulatory activities in the area of financial market legislation.

TOO BIG TO FAIL – STRENGHTENING OF THE STABILITY IN THE BANKING

As a consequence of the financial crisis and the rescue of UBS by the Swiss Confederation and the Swiss National Bank ("SNB"), Switzerland, as of March 1, 2012, as one of the first countries worldwide, introduced special rules for systemically relevant banks. The "too big to fail" package of measures requires from systemically relevant banks a strengthening of the equity capital, an increase in liquidity, improved risk diversification and better organizational measures. The latter measures are aimed at permitting a systemically relevant bank, in the case of pending insolvency, to continue to carry out systemically important functions for the economy such as, for example, payment transactions. To date, the SNB has designated UBS, Credit Suisse Group, SIX Swiss Exchange and Zürcher Kantonalbank as systemically relevant.

Furthermore, on January 1, 2013, stricter requirements in terms of capital backing entered into force. Switzerland has therefore implemented the new requirements of Basel Committee on Banking Supervision (Basel III). With respect to the systemically relevant banks, Switzerland imposes capital requirements that are stricter than those under the Basel III rules.

As an additional measure to strengthen the banking sector, in September 2013, due to the strong credit growth and the rising real estate prices, the Federal Council activated the so-called counter-cyclical capital buffer and, in January 2014, increased it to 2%. Thus, the banks are required to back up mortgage loans for residential real estate with increased capital. This measure is intended to strengthen the resilience of the banks in connection with excessive credit growth and counteract the formation of a real estate bubble.

The granting of mortgage loans is intended to be further throttled within the scope of self-regulation, through various minimum requirements of the Swiss Bankers Association with respect to mortgage financing.

THE NEW FINANCIAL MARKET INFRASTRUCTURE ACT

After strengthening the regulation of banks, the Federal Department of Finance FDF ("FDF") and the Swiss Financial Market Supervisory Authority FINMA ("FINMA") recognized a need for regulation with respect to financial market infrastructures. This term refers to infrastructures by means of which market participants are able to trade, settle and clear individual financial instruments. These include stock exchanges and other trading markets, central counterparties, central depositaries and transaction registers. Even though these financial market infrastructures are of central importance to the functioning and stability of the financial system, they are covered by current regulations only on a piecemeal basis.

The new Financial Market Infrastructure Act governs the organization and the operations of financial market infrastructures as well as the rules of conduct of market participants in connection with securities and derivatives trading.

Likewise, the current regulations fail to lay down requirements that satisfy the international recommendations with respect to trading in over-the-counter derivatives (so-called OTC derivatives). The financial crisis has demonstrated that the important OTC derivatives market has shortcomings in terms of transparency and collateralization that can endanger the stability of the financial system.

It is intended that these gaps in regulation be closed through a new federal law on financial market infrastructures (the „Financial Market Infrastructure Act") that the Federal Council submitted into the consultation process on December 13, 2013. The Financial Market Infrastructure Act should govern in a uniform and comprehensive manner, as a matter of supervisory law, the organization and the operations of financial market infrastructures as well as the rules of conduct of the market participants in connection with securities and derivatives trading. According to the preliminary draft, important areas of regulation will for these purposes be transferred from the current Stock Exchange Act to the new Financial Market Infrastructure Act.

Swiss financial market legislation is currently undergoing a fundamental change, but the end structure of the new architecture is not yet foreseeable at the present time. What lies at the center of the regulatory projects is the creation of uniform rules (a level playing field) for the financial market participants.

Andreas Bättig, Attorney-at-Law, lic. iur., LL.M.

THE NEW FINANCIAL SERVICES ACT

Based on the investigative results of the Madoff and Lehman Brothers cases, the FINMA also determined a need for regulatory action in the area of customer protection. The FINMA found, among other things, that the financial service providers did not sufficiently ascertain the risk awareness and risk tolerance of the clients and that the clients were not being adequately informed about the costs and risks of the financial products being distributed.

The new Financial Services Act is aimed at improving customer protection at the point of sale and includes all professional financial service providers on a cross-sector basis.

Based on this finding, the FINMA launched the cross-sector "Distribution Rules" project. For these purposes, it published a "Distribution Report" in 2010 in order to regulate the creation and distribution of financial products to private clients, which it supplemented in 2012 with a "Distribution Rules" position paper. In February 2013, this was followed by the hearing report of the FDF.

The most important objective of the "Distribution Rules" project is to improve customer protection in the Swiss financial market. In contrast to the requirements to date, which only apply to certain types of financial service providers depending on the sector and are not uniform, the new approach is intended to apply across sectors and on a consistent basis for all professional financial service providers, irrespective of their license status.

In essence, the FINMA and the FDF wish to achieve improve customer protection through the following measures within the scope of a new Financial Services Act:

Rules for Financial Products (Prospectus Obligation)
For all standardized financial products offered in Switzerland, a prospectus is to be issued that sets out both the information concerning the product creators and the product that is material to the investment decision as well as risk disclosures. In the case of complex financial products, private clients are to be provided a so-called Key Investor Document (KID) that follows a strict scheme and that is intended to explain the material characteristics of the fi-

The transparency of the financial market should be increased for all market participants through new regulations in order to even out the informational imbalance between clients and providers of financial products. The implementation of these requirements will represent a major challenge for all participants in view of the on-going constant change of the regulated financial market.

Urs Leu, Attorney-at-Law, Dr. iur.

nancial product in easily understandable language.

Expanded Rules of Conduct and Organizational Rules for Financial Service Providers
With respect to the distribution of financial products, expanded rules of conduct and organizational rules are intended to apply to financial service providers. Such rules may provide, among other things, that the client must be informed prior to the investment decision about the content, characteristics, costs and risks of the product. Likewise, financial service providers must transparently inform clients about third party remuneration and avoid conflicts of interest. Each financial service provider having client contact (point of sale) should furthermore have a certified training and undergo regular further training. The financial service providers should, in addition, be subject to expanded obligations in terms of documentation and accountability.

Simplified Enforcement of Claims
Furthermore, the Financial Services Act is intended to make it easier for clients who have suffered damages to enforce their claims. What has been proposed, namely, is a reversal of the burden of proof in favor of the bank client, a strengthening of the ombudsman system and an obligation on the part of the financial service providers, under certain circumstances, to cover or advance the costs of legal disputes.

Cross-Border Activities in Switzerland
Finally, it is intended that the Financial Services Act will also regulate the cross-border provision of financial service in Switzerland. In particular, foreign financial service providers should be made subject to the same rules of conduct that apply for Swiss providers as well.

It is anticipated that the Federal Council will soon submit a preliminary draft of the Financial Services Act into the consultation process.

THE NEW FINANCIAL INSTITUTIONS ACT

In close connection with the Financial Services Act, the FDF is proposing the issuance of a new Financial Institutions Act intended to govern the types of licenses and requirements for financial intermediaries, the liquidation of the same as well as the recognition of foreign financial intermediaries. As an important innovation, the Financial Institutions Act is also intended to subject independent asset managers – who are currently not regulated – to comprehensive prudential supervision.

In this manner, one of the last unregulated areas of the financial market should be placed under permanent supervision and a level playing field should be created between the various financial market participants. What has not yet been clarified at the present point in time is whether the FINMA or a new separate supervisory organization will exercise supervision over the independent asset managers.

A consultation draft of the Financial Institutions Act is anticipated soon, at the same time as the preliminary draft of the Financial Services Act.

Through the new Financial Institutions Act, independent asset managers should now also be placed under prudential supervision.

SUMMARY AND ASSESSMENT

As can be seen from the summary above of selected regulatory projects, the Swiss regulators are currently engaging in an extraordinarily high level of reform activities. In connection therewith, the various regulatory projects in part provide for far-reaching changes in laws that were revised only a short time ago.

The regulations that are pending in the near future are focused, on the one hand, on a strengthening of customer protection at the point of sale through better risk and cost disclosure to the clients and improved training of client advisers, supplemented by simplified procedures for the enforcement of client claims. Another important change consists of the subjection of hitherto-unregulated asset managers to prudential supervision that is being contemplated.

Because the regulators have not to date presented any comprehensive overall concept for a restructuring of the financial market legislation and because regulatory projects are presented only on a step-by-step basis, there are not currently any reliable indications as to a possible final structure of the new architecture. Already now, however, it can be seen that the plethora of new legislation will profoundly restructure the currently-familiar legal bases of financial market legislation. The regulatory projects, if they are implemented, will undoubtedly present new challenges for the entire financial marketplace.

In view of the upheavals that the Swiss financial industry has suffered in the past years as a consequence of the financial crisis and in connection with the tax problems, the regulators would be well-advised to exercise moderation in shaping the new regulations, also taking into consideration the cost consequences for the financial service providers, and not lapse into over-regulation. This should, of course, not prevent the implementation of justified objectives such as, for instance, the creation of a level playing field. §

Andreas Bättig

An efficient, quick-acting financial market supervisory authority that takes consistent and vigorous action in the face of wrongdoing is imperative for confidence in the financial marketplace. In connection therewith, measured judgment must not be overlooked.

Désirée Wiesendanger, Attorney-at-Law, lic. iur., LL.M.

Financial Market Enforcement by FINMA – Always with Measured Judgment?

In case of breaches of the financial market laws - including, among others, the Banking Act and the Stock Exchange Act - FINMA, within the scope of financial market enforcement, takes the neccessary measures and imposes the necessary sanctions in order to restore the proper situation, whereby this must be done in conformity with the principle of proportionality.

CONCEPT AND OBJECTIVES OF FINANCIAL MARKET ENFORCEMENT

The Swiss Financial Market Supervisory Authority FINMA regulates and supervises the Swiss financial market. If FINMA determines that there has been a breach of the financial market laws, it enforces supervisory law with the compulsory measures provided by law. Therefore, the concept of "financial market enforcement" must be understood to comprise all activities of FINMA that are aimed at investigating, correcting and, as the case may be, sanctioning breaches of financial market legislation.

For purposes of enforcing financial market legislation, FINMA has at its disposal a wide spectrum of supervisory instruments. These instruments are not limited to institutions that are subjected to the oversight of FINMA. Because FINMA must generally oversee adherence to the financial market legislative provisions, its remit also includes the investigation and sanctioning of companies and persons who engage in a financial market law activity without holding the necessary license or authorization. The statistics clearly show that even more court decisions are issued in this area than with respect to institutions that are subject to the oversight of FINMA.

SELECTED INSTRUMENTS OF FINANCIAL MARKET ENFORCEMENT

Occupational ban

If FINMA finds that there has been a serious breach of provisions of supervisory law, it may prohibit the person responsible from exercising a managing function at an institution supervised by FINMA for a duration of up to five years. By restricting career development, an occupational banrepresents a considerable limitation on the economic freedom of the affected person and, as such, must uphold the principle of proportionality – also with respect to duration – that is anchored in the Constitution. On the other hand, however, the general interest in the protection of the public from activities of persons who have already once seriously breached supervisory law obligations must also be taken into consideration.

As in the case of each governmental act, the financial market legislation measures of FINMA must be taken in conformity with the principle of proportionality.

Publication of the Supervisory Ruling of FINMA

If there has been a serious breach of provisions of supervisory law, FINMA may publish its supervisory ruling in electronic or print form and include personal data. This "naming and shaming" is based on the idea of a denunciatory effect. On the one hand, the affected person should be deterred, through the publication, from again breaching provisions of financial market legislation. At the same time, however, through the deterrent denunciatory effect of the naming of names, this measure is also intended to have a general deterrent effect for purposes of the protection of the public. Publication of the supervisory ruling with the naming of personal data is a serious intrusion into the general and economic personal rights of the affected person. Such a publication is justified for purposes of the protection of the public, in particular, if the repetition of serious misconduct appears probable. However, a one-off, isolated and minor breach of provisions of financial market law is not sufficient for these purposes.

Liquidation of Illegally Active Financial Intermediaries

In analogous application of the withdrawal of a license in the case of institutions that are subject to the oversight of FINMA, FINMA may decree the liquidation of companies that are engaged on an unlicensed basis in an activity that is subject to a licensing requirement under the financial market legislation. This undoubtedly represents a very drastic measure, which is why FINMA, based on the principle of proportionality, must review whether any more lenient measure comes into question. The liquidation should remain a measure of last resort (ultima ratio).

In a recent widely-noticed decision, the Federal Supreme Court expressly held that financial market legislative measures – as in the case of each governmental act – must also be proportionate and primarily take into account investor protection. Therefore, even measures of FINMA must not extend beyond what is necessary in order to restore compliance with the law. In the above-referenced decision, what was at issue was the appropriateness of the liquidation of a company that was engaged in activities within the scope of a group of companies and that pursued both an activity subject to a license requirement as well as an activity that was unobjectionable from a financial market law perspective. The Supreme Court concluded that companies that primarily subsist based on activities that are illegal under financial market legislation and that endanger creditors should be liquidated, but not companies that are not indubitably part of a larger system and that pursue a legal activity, with a possible isolated disregard for obligations under financial market legislation. The Supreme Court deemed the liquidation ordered by FINMA in the case at hand to be disproportionate.

Among legal commentators, voices have increasingly been raised that criticize an all-too brash approach to financial market enforcement by FINMA.

FINANCIAL MARKET FORCEMENT WITH MEASURED JUDGMENT?

This is stated, at least, in the "FINMA Enforcement Policy", most recently updated in November 2011. In this publication, FINMA presents, in 13 principles, its point of view on financial market enforcement. In Principle 3, entitled "Enforcement with Measured Judgment", it can be read that FINMA, prior to instituting an enforcement proceeding, "considers all the relevant circumstances carefully and explores alternative options." It is true that this must occur in any case, automatically, based on the principle of proportionality that applies to the acts of FINMA. Nonetheless, it is a welcome step that FINMA itself states this so clearly, since voices have increasingly been raised among legal commentators that criticize an all-too brash approach to financial market enforcement by FINMA. §

Désirée Wiesendanger

When accepting new funds, financial intermediaries will have to account for money laundering and terrorist financing as well as for tax compliance aspects. New due diligence rules shall prevent the acceptance of undeclared funds.

Natalie Peter, Attorney-at-Law, Dr. iur., LL.M.

Switzerland's Financial Integrity Strategy

Switzerland is faced with multiple challenges in the area of international financial and tax matters. Although the Swiss government is trying to turn these challenges into an opportunity to maintain a sound Swiss business location respective new legislation substantially impacts the wealth management sector.

THE FINANCIAL INTEGRITY STRATEGY

During 2012 the Federal Council confirmed that it would be pursuing a clear financial market policy and detailed on its strategy for a competitive, tax-compliant financial centre straddling two: firstly, past tax issues shall be resolved, particularly in the cases of clients domiciled abroad whose assets have not been properly taxed. Secondly, international cooperation and the future taxation of capital income and gains shall be formally regulated.

The Financial Integrity Strategy contains three components:

a. A final withholding tax regime which taxes taxpayers in accordance with the rules of their country of domicile while at the same time protecting their privacy

In its efforts to implement a strategy to regularise untaxed foreign assets held in Switzerland, a withholding tax agreement with both the UK and Germany was signed in 2011. The European Commission expressed reservations about the compatibility of those withholding tax agreements with the savings tax agreement between the EU and Switzerland. By adding corresponding adjustments, Switzerland was able to remove these concerns. A third agreement was concluded with Austria in April 2012. All three agreements were approved by Swiss parliament during the 2012 summer session. While the UK and Austria approved the agreements during the course of 2012 - both agreements entered into force on January 1, 2013 - Germany's parliament did not accept the agreement.

b. The improvement of administrative and mutual assistance in accordance with international standards

International pressure on Switzerland to cooperate more closely in the fight against tax offences continuously increased. Thus, in 2009 the Federal Council decided to expand administrative assistance in tax matters in accordance with the international standard and to include the standard-compliant administrative assistance provision (Article 26 of the OECD Model Convention) in all newly negotiated double taxation agreements.

c. **The introduction of due diligence requirements for financial intermediaries in order to ensure that no undeclared assets are invested in Switzerland.**

In its 2013 report on international financial and tax matters, the Federal Council confirmed that it was stepping-up its efforts to combat abuses in the areas of money laundering and tax. By swiftly implementing the revised international recommendations on combating money laundering and terrorist financing, Switzerland tried to emphasise its high level of commitment entered through its international engagement.

International pressure on Switzerland to cooperate more closely in the fight against tax offences continuously increased.

On February 27, 2013 the government passed two draft bills proposing new legislation to combat money laundering and prevent tax evasion. While the first draft bill aimed primarily at implementing the Financial Action Task Force (FATF) recommendations into national legislation, the second should have introduced new diligence duties for banks and other financial service providers in order to keep untaxed money away from the Swiss financial sector.

REVISED FATF RECOMMENDATIONS

The draft bill on the implementation of the revised FATF recommendations contains a couple of key points:

a. The anonymity of holders of bearer shares shall be eliminated and a general obligation of companies to identify their beneficial owners introduced.
b. The acceptability of cash payments in sales and purchase transactions shall be restricted to the amount of CHF 100,000.
c. Tax fraud would be a predicate offence to money laundering.
d. The definition of a politically exposed person in the Swiss anti-money laundering legislation shall be extended to national politically exposed persons as well as to persons closely connected with a politically exposed person.

FATF added "punishable tax offences" to its list of offences automatically constituting a predicate offence to money laundering. The term “tax offence” must be defined according to domestic law. Accordingly, the Swiss government proposed to consider serious tax offences only as predicate offences to money laundering. Consequently, the draft provisions provide that tax fraud will no longer be a mere misdemeanour but a serious crime, provided that the avoided tax amounts to at least CHF 200’000. Tax fraud is committed when using false or falsified documents. Mere tax evasion (as opposed to tax fraud) would therefore not become a predicate offence to money laundering in Switzerland.

The financial market strategy being pursued by the Federal Council and the concomitant fundamental reforms of the financial market legislation represent a challenge not only for FINMA as supervisory body, but also for the financial market law stakeholders. Staiger Schwald & Partner has competent specialists who are able to provide comprehensive advice within the framework of these reforms.

DUE DILIGENCE REQUIREMENTS

The proposed law imposes new due diligence duties on financial intermediaries in order to prevent tax evasion, which are comparable to those applicable when combatting money laundering and terrorist financing.

Financial intermediaries such as banks, insurance companies, securities traders, asset managers or fiduciaries would be obliged to verify, when accepting assets from new or existing customers, whether these assets are taxed or will be taxed in the relevant jurisdiction (typically the country of residence of the customer).

The scope of investigations to be carried out by a financial intermediary shall depend on the specific risk of non-compliance with tax laws involved (so called risk-based approach). The Anti-money laundering Act would contain a non-exhaustive catalogue of indicators of the increased, as well as reduced, risk of non-compliance.

OUTLOOK

In November 2013 the Federal Council responded to the concerns raised by the financial industry and resolved that the new requirements are to be discussed in coordination with the conclusion of possible agreements on the automatic exchange of information between Switzerland and its main partner countries. The Federal Council considers that an internationally recognised standard for the automatic exchange of information will exist in the foreseeable future, and that new agreements will be necessary for its implementation. Enhanced due diligence requirements shall therefore apply additionally for those states where no such agreement exists. §

Dr. Natalie Peter