

Switzerland's new financial market architecture

François Bianchi, Thomas Frick, Sandro Abegglen and Marco Häusermann of Niederer Kraft & Frey provide an overview of new financial market regulations in Switzerland and what they mean for market participants

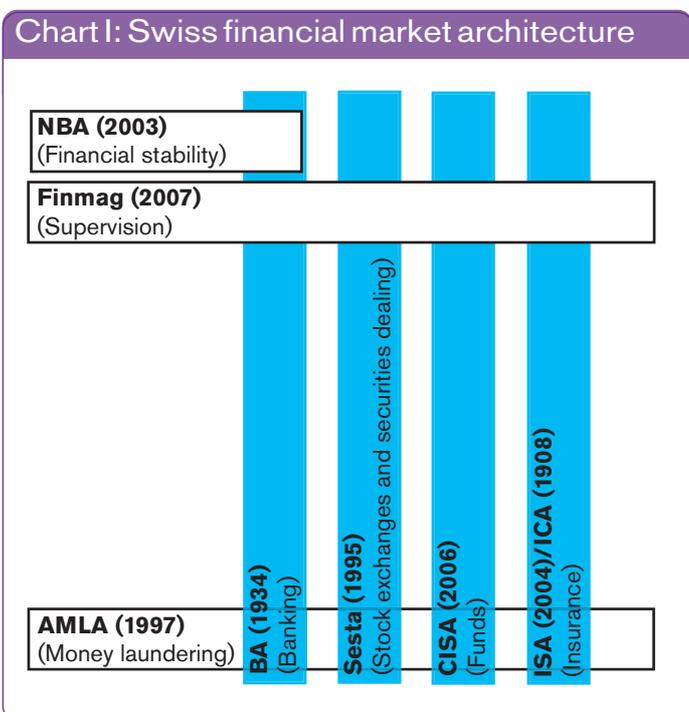
The Swiss Government has published drafts of three new statutes, which will completely overhaul the existing Swiss financial market regulation. The drafts still need to go through the legislative process, which is expected to be completed by 2018 or 2019. The new regulation on financial market infrastructures may enter into force as soon as 2015 or early 2016.

Given the materiality of the changes, participants in the Swiss financial market, whether domiciled in Switzerland or abroad, will need to assess in time the potential impact of these new rules on their business and take appropriate action.

From old to new: an overview

The existing financial market architecture in Switzerland is based on a vertical pillar model. If the entire house is the Swiss financial market, the legislator has thus far deemed it sufficient to only build (regulate) certain pillars. Each pillar has been given its own shape and form, and as such, plenty of empty spaces have remained in between those pillars.

The following chart serves as illustration of the existing Swiss financial market architecture

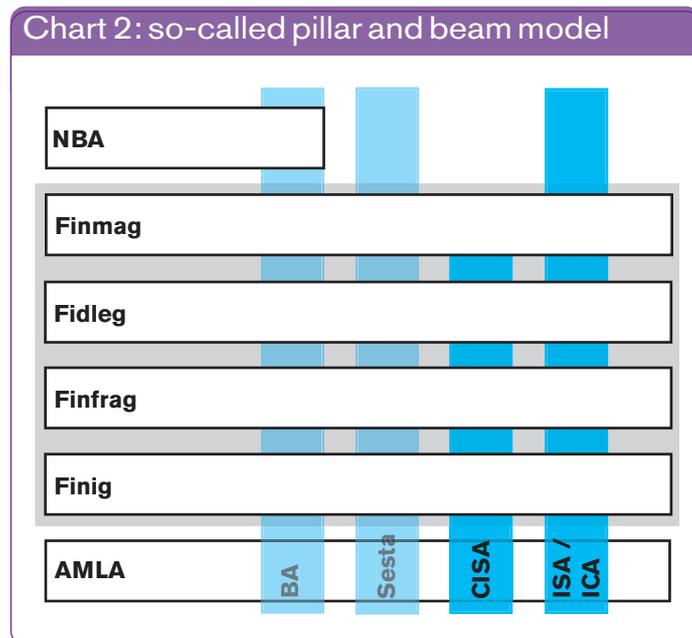


In contrast to the existing pillar model, the new Swiss financial market architecture will work with both vertical pillars and horizontal beams, as it were. While certain vertical product- or sector-oriented regulations (such as the collective investment schemes act or CISA) will remain in place, areas suitable for a harmonised regulation across different sectors will be carved out and incorporated into the new horizontal financial market acts. The future architecture will comprise different levels of regulation (such as product level, institution level, infra-structure level, point of sale level,

and supervision level), which will, for example, facilitate subjecting certain financial service providers, such as client advisors, to point of sale duties, while not introducing a licensing requirement at the institution level.

Four acts will constitute the core of this new horizontal regulation: (i) the existing Financial Market Supervision Act (Finmag) for supervision; (ii) the new Federal Financial Services Act (Fidleg) for products and point of sale; (iii) the new Financial Market Infrastructure Act (Finfrag) for infrastructure; and, (iv) the new Financial Institutions Act (Finig) for institutions.

The following chart illustrates the so-called pillar and beam model.



From a conceptual point of view (not yet accounting for content), the main advantage to the new architecture is that it will allow for greater coherence and adherence to the principle of same business, same rules. A disadvantage, however, might be that market participants will be required

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to consult various acts to ensure compliance in their day-to-day operations. For example, a company exclusively active in the fund business (such as an asset manager and distributor of funds) does not under the existing regime need to consult many acts other than CISA and its implementing ordinances. This was accompanied by the need to consult and be aware of the corresponding Finma (Swiss Financial Market Supervisory Authority) and Swiss Funds and Asset Management Association (SFAMA) circulars, public notices, and FAQs. They will now, under the new regime, have to consult Finig and its implementing ordinances (regarding the organisational requirements on institution level), Fidleg and its implementing ordinances (regarding marketing funds to potential investors), Finmag (when dealing with the supervisory bodies), and CISA and its implementing ordinances (for sector-specific regulations).

Finmag

Finmag entered into force on January 1 2009 and is, therefore, not a new regulation. While it will be partly amended through the introduction of the Finfrag, Finig, and Fidleg, its core will remain unaffected. It remains undecided whether asset managers (which will become subject to supervision) will be supervised by Finma directly or by a new semi-public supervisory authority, which, in turn, would be supervised and guided by Finma.

Amendments discussed include new rules for cross-border information flow. Finma will be entitled to spontaneously (without a formal request) exchange information with foreign authorities (not limited to supervisory authorities), provided that such information exchange serves the purpose of enforcing financial market regulations and that the foreign authority is bound by official or professional secrecy. In administrative assistance proceedings, it is suggested that Finma will have the option not to inform the client before client information is delivered to a foreign authority. Further, in such cases, the client may be refused access to the formal request filed by the foreign authority. Therefore, the proposed amendments would massively limit clients' rights to be heard.

Finfrag

The draft Finfrag provides for a consolidated and comprehensive set of rules for the supervision of financial market infrastructures (FMIs). It will replace the existing fragmented regime for FMIs consisting of provisions that can be found in a variety of different acts (such as the Banking Act, the Stock Exchange and Securities Dealing Act, and the National Bank Act) and ordinances. Finfrag further introduces new regulations and obligations for market participants in the area of derivatives trading. The core reason for the new Finfrag is to align the Swiss regime with international standards, in particular with EU regulations such as MiFID II, MiFIR, Emir and CSDR, in order to preserve Switzerland's global competitiveness in these areas.

Financial market infrastructures

Finfrag will introduce new licensing requirements and regulations for the following categories of FMIs: trading venues (stock exchanges and multilateral trading facilities or MTFs); central counterparties or CCPs; central securities depositories or CSDs; trade repositories; and payment systems.

Further, Finfrag also regulates organised trading facilities (OTFs) that are operated within Switzerland.

Key differences to the EU regulations under the Swiss regime are the following: (i) self-regulation with respect to trading venues (such as admission of participants) continues to play an important factor; (ii) there is no prohibition for an operator of an OTF to trade on its platform for its own account, but measures must be taken to avoid conflicts of interest in such situations; (iii) links among central securities depositories are subject to regulation; and, (iv) the transfer of data between a Swiss trade repository and foreign authorities is more restrictive.

Derivatives trading

To safeguard the competitiveness of the Swiss financial centre, strengthen financial stability, maintain the ability of Swiss market participants to access foreign markets and enable Swiss participants to take advantage of certain exemptions granted under foreign regulations (in particular under Emir and the US Dodd-Frank Act), it is necessary for Switzerland to implement equivalent standards on derivatives trading as fully as possible in parallel with other financial centres. The core obligations imposed on Swiss market participants are: (i) the clearing of derivatives transactions through central counterparties; (ii) the reporting of derivatives transactions to trade repositories; (iii) risk-mitigating measures consisting of the posting of adequate collateral to mitigate counterparty risk, the daily valuation of the derivative at market prices, and the obligation to organise operations to reduce operational risks; and, (iv) a platform trading obligation (once implemented by Finma).



Financial services and product documentation, even if cross-border into Switzerland, will be stricter regulated
Finig will provide for harmonised, cross-sectorial regulation in order to 'create a level playing field for the supervised institutions'

Key differences to the EU regulations are that under the Swiss regime: (i) the concept of small counterparties is established due to the fact that many smaller market participants are active in the Swiss market; (ii) FX swaps and futures only trigger the reporting obligation but no other obligations; (iii) asset managers that do not manage collective investment schemes and investment advisors will qualify as non-financial counterparties, whereas they qualify as financial counterparties under Emir; (iv) group internal transactions are not subject to authoritative approval, but compliance with the rules is controlled by the participants' auditor; and, (v) the reporting obligation will not require the disclosure of the beneficial owner.

Finig

Finig is in draft form and subject to change as a result of the Federal Council's consultation procedure, to be followed by parliamentary review. The draft legislation introduces a differentiated supervisory and regulatory regime for financial institutions (as specified below), which provide asset management services to third parties. It aims to become a framework law that will govern the licensing requirements and further organisational conditions for financial institutions. The aim of Finig is to: (i) enhance the functionality of the financial market; and (iii) increase the stability of the financial system. The new regulation further looks to improving market conditions, reducing conflicts of interest and increasing the attractiveness of the Swiss market for asset management. Finig will provide for harmonised, cross-sectorial regulation in order to 'create a level playing field for the supervised institutions'. In particular, the following aspects relevant to financial institutions are intended to be regulated under Finig: organisation of institutions; licensing requirements; supervision of

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institutions; foreign financial institutions doing business in Switzerland: tax compliance due diligence when accepting assets; insolvency measures; and, sanctions.

The new Finig will apply to the following financial services providers, irrespective of their legal form: independent asset managers (certain grandfathering exemptions will apply); qualified asset managers (asset managers of collective investment schemes and asset managers of Swiss occupational benefits schemes); fund management companies; securities houses (classified as security traders); and, banks.

Finig will not apply – among others – to persons who exclusively manage assets of persons to whom they have economic or family links or exclusively manage assets in the framework of employee participation plans. In particular, the exemption also comprises the activities of: (i) a family member for the family office of his family; and, (ii) persons, who without being related to the family, are employed to manage a single family office that solely manages its own financial assets and is controlled by a family member.

Fidleg

Fidleg will comprehensively govern both the rendering of financial services and the product documentation in respect of financial instruments. The new law will apply across all financial services sectors to banks, broker-dealers, insurers (for life products with an investment component), fund management companies, asset managers, product distributors, and investment advisors, whenever they are providing services, or distributing, issuing or offering products that are in scope of Fidleg. Special rules at product level will remain to be set out in CISA for collective investment schemes (CIS) and in the insurance regulation. However, the existing regulation of the distribution of CIS in CISA will likely be substituted by the general Fidleg rules applicable to any point of sale activity.

Rules, including client protection rules, will be harmonised with EU rules

More specifically, regarding the scope of Fidleg, financial services are the following activities provided for clients: purchase and sale of, and acceptance and transmission of orders regarding financial instruments; asset management; providing of personal recommendations in respect of financial instruments (investment advisory); any type of marketing for and distribution of financial instruments; custody of financial instruments for the account of clients; and granting of loans in connection with transactions in financial instruments. The term financial instruments is defined very broadly by the draft and basically includes any type of instruments into which an investment of financial assets may be made, such as shares, bonds, CIS, structured products, life policies with investment component, derivatives, and money market instruments.

In line with Fidleg's goal of providing for more investor protection and opposition to the often applied principle of strict territoriality, Fidleg – for the first time in Swiss financial services regulation – provides a general regulation on the rendering of services and product offerings done on a pure cross-border basis (without permanent, substantial presence in Switzerland) from abroad to Switzerland. Under the existing liberal regime, only CISA and the insurance regulation set out rules on such inbound cross-border business. Such providers will have to register with Finma, will have to comply with the extensive conduct duties of Fidleg,

and fulfil the Swiss product documentation requirements, notably prospectus and basis information sheet requirements.

These conduct and prospectus requirements, which of course also have to be fulfilled by Swiss domiciled providers, are – at least according to the Fidleg consultation draft – quite similar to the respective obligations under MiFID II. This is not surprising, as the Swiss Government wishes to implement a regulation that should be regarded as equivalent by the EU in view of facilitating market access for Swiss financial services providers to the European market. Conduct duties include comprehensive information duties, appropriateness and suitability obligations, a need for client segmentation, rules on inducement and retrocessions in general, cost transparency requirements, conflict of interest rules, and rules on dependent financial service providers versus non-independent ones.

The product documentation requirements are similar to the ones applicable within the EU. A novelty will be that prospectuses for public offerings of financial instruments will need to be approved by an authority, which so far is only the norm in the highly-regulated CIS and insurance world.

Controversial are the sections that facilitate an investors' enforcement of its civil claims related to financial instruments against financial services providers, and the new criminal sanctions that would apply even to non-intentional breaches of the conduct and prospectus duties, which complete the proposed act.

It is already evident that the proposed rules on civil law enforcement will find substantial opposition in parliament, although it remains to be seen how Swiss politicians will react to the proposal. Any concerned Swiss and foreign market participant should be aware that Fidleg's main body almost certainly will pass through Swiss parliament (maybe with certain compromises) and will soon become the new standard to be complied with.

Specifically, foreign market participants will have to consider the following key points in respect of their services to the Swiss market: (i) registration duties for foreign financial services providers; (ii) compatibility of EU regulations with Swiss regulations; and (iii) compliance with the new conduct duties.

In respect of products offered into Switzerland, apart from the specific CISA and insurance regulatory aspects, foreign financial instruments providers should be aware of and prepare for the following: (i) new rules regarding the prospectus requirements for financial instruments that are offered in Switzerland, in particular new duty of prospectus approval for public offerings; (ii) basis information sheets for Switzerland; (iii) appropriate client information and marketing documentation; and (iv) key points for Swiss financial instruments providers.

CISA deadline

CISA was revised with effect as of March 1 2013. This CISA revision has already led to a fundamental change in terms of the regulation for the distribution of foreign CIS into Switzerland and within Switzerland. The formerly available private placement exemptions under which foreign CISA could be marketed to certain types of qualified investors without any regulatory implications, be it on product level or on distributor level, has been abandoned and replaced by a stricter regime. In this context, a transition period was granted until February 28 2015. After this date, the distribution of foreign CIS into or within Switzerland to qualified investors now requires the following conditions to be met: (i) a Swiss regulated representative and Swiss regulated paying agency bank must be appointed by the foreign CIS (product level); (ii) the fund documentation must contain the necessary disclosures on costs and commissions and on their use, in particular if used to compensate third parties (product level); (iii) distribution may only be made based on distribution agreements to be entered into (also) with the Swiss regulated representative (distribution

level); (iv) the party engaging in distribution must have the status of a CISA distributor, that is, they must be licensed as a CISA distributor (or higher) by Finma or in the case of a foreign party, be under adequate foreign supervision (distribution level); and, (v) the distributor must comply with certain rules of conduct (distribution level).

New regulations for financial market infrastructures and derivatives trading are pending

Adapting to the sea-change

The new regulations will fundamentally change the legal framework for any participant in the Swiss financial market, regardless of whether it is a Swiss or a foreign entity. Their existing business model will need to be reviewed and evaluated as to whether and to what extent it needs to be adapted to comply with the upcoming comprehensive changes to the Swiss regulatory financial market architecture.



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