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Enforcement of Rights by Investors
Consultation for FIDLEG and FINIG - Part IV

The Swiss government opened a consultation process for the draft bills of a Financial Services Act and a Financial Institutions Act. These two projects will completely reshape the regulatory framework governing the Swiss financial markets. It includes 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, as well as comprehensive rules aiming to facilitate access to justice, including through a form of class actions.

The consultation process runs until 15 October 2014. The Federal Council plans to send the bill of the Financial Services Act and the Financial Institutions Act to parliament in Q2 2015.

In this fourth briefing on the draft bills, we analyse the regulation FIDLEG provides in relation to the enforcement of rights by investors.

Background

The draft bill of the Swiss Financial Services Act (FIDLEG) aims to significantly improve the enforcement of rights by clients of financial services providers. According to the explanatory report, the current legal system makes it too costly (or otherwise too cumbersome) to enforce claims for damages suffered. Deterrents of particular importance are:

- The risk of paying high court fees and counterparty compensation;
- The lack of an instrument for collective action (class action).

Against this background, the Swiss government proposes sweeping reforms to improve the enforcement of rights by clients against financial service providers that gave insufficient investment advice. As such, it applies to banks, securities houses, portfolio managers and asset managers, as well as investment advisers, regardless whether they are licensed or not, but not issuers of financial instruments.

Main Changes

FIDLEG contemplates the following changes:

- a stricter duty of the financial service provider to produce all documents related to a client and his or her investments at the request of such client;
- a shift of the burden of proof to the financial service provider as to the compliance with its statutory information and disclosure duties;

- a mediation procedure based on an Ombud system;
- either a simplified and efficient arbitration procedure for financial service disputes or a 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;
- collective action against financial institutions for the benefit of clients by interest groups including the possibility to enter into settlement arrangements.

The proposed rules regarding the burden of proof and the introduction of actions and other powers by interest groups on behalf of a class of clients are likely to have the most significant practical impact. These concepts are therefore discussed in more detail hereafter.

Burden of Proof

The proposed article 74 FIDLEG states plainly that the financial service provider bears the burden of proving that it complied with its statutory information and disclosure duties. Whereas the new provision seems to refer to the duties set out in the conduct rules of the second title and first chapter of FIDLEG, the liability for prospectuses and similar disclosure documents appears to be out of scope (article 69 FIDLEG provides for a specific rule covering prospectus liability). Furthermore, the proposed reversal of the burden of proof seems to apply only to relationships between financial service providers and their clients (as opposed to investors generally).

As a consequence of shifting the burden of proof, the financial service provider is presumed to have breached the required standard of care if a client alleges such breach with a sufficient degree of specificity. It is then up to the financial service provider to prove that it complied with its information and disclosure duties. This will require diligent documentation and robust records within the organization of the financial services provider. If it fails to demonstrate compliance with its duties the court will presume that the client would have abstained from the transaction causing the loss. In other words, once the plaintiff proves a loss, the financial service provider will need to exonerate itself from the presumptions stipulated by FIDLEG regarding three of the four requirements for a successful claim for damages (loss sustained, breach of a duty, causal nexus between breach and loss sustained, and fault).

Consequently, any failure of a financial service provider to disclose one of the items specified by the FIDLEG (such as address, relevant custodian, services offered; cf. article 7 FIDLEG) appears to trigger the legal presumption that the client would have abstained from the relevant transaction even if the item omitted to be disclosed had no or little relevance for the investment decision made and no connection with the loss sustained. The proposed new liability regime thus comes close to one of strict liability (*Kausalhaftung*), which may yield counter-intuitive results.

Collective Action by Interest Groups

The proposed rules on actions by interest groups are another distinct feature of the FIDLEG. Rather than adopting U.S. style class actions the Swiss government follows European concepts for collective action, such as the model established in the Netherlands. It is based on independent non-profit organizations acting as protectors of the interest of clients. FIDLEG does not provide for any specific approval or admission procedure for interest groups as long as they satisfy FIDLEG's requirements, *i.e.*:

- legal personality;
- operation on a non-profit basis; and
- purpose to observe the interest of customers of financial service providers or of consumers.

Eligible interest groups may tap the fund for litigation costs set up by the FIDLEG. However, since this fund may not outlast the consultation process, it remains unclear how these interest groups will fund their activities.

Interest groups may not claim damages from financial service providers. However, they may apply to a competent court (or arbitral tribunal if applicable) for a declaratory ruling or injunctive relief. The court may order the financial service provider to refrain from breaching the pertinent duties. More importantly, interest groups may petition the court to issue a declaratory ruling that a breach of a duty by a financial service provider has taken place, "provided that there is a legitimate interest for such confirmation". How the shift of burden of proof described above would affect such a lawsuit by an interest group is not clear. Presumably, it will apply also to proceedings which interest groups initiate as a matter of principle. However, a financial service provider can continue to object and prove that, in a specific instance, the client does not belong to the class of affected clients or did not incur a loss following the breach, e.g. because the client did not incur a loss or there was not causal nexus in the specific case.

Interest groups may, on behalf of a class of investors, also enter into settlement arrangements with financial service providers setting out the financial consequences of actual or alleged breaches of law. FIDLEG sets out the content of these arrangements in detail. In order for an arrangement to become binding, the parties of the settlement need to submit it to the competent court for approval. Among other things, the court will have to verify whether the compensation payable to investors pursuant to the settlement arrangement is fair and whether the beneficiaries of such compensation are indeed the persons who incurred a damage.

Once a settlement arrangement has been approved by a court, a client affected by the arrangement may still "opt out" by declaring, within a period set by the court (three months at the minimum) that the arrangement shall not be binding for him or her. Either party, the interest group or the financial service provider, may revoke a settlement arrangement in case more than a third of the affected individuals have opted out of the arrangement. The law provides for a per capita threshold; the level of compensation attributable to the persons opting out is not relevant. In any event, the possibility left to an investor to opt out leaves the financial service provider exposed to the need to litigate the matter with such investors after having gone through a lengthy settlement process.

Criminal Provisions

In order to ensure strict compliance with the law, FIDLEG promulgates certain criminal provisions. These provisions relate to breaches of law in connection with prospectuses and key information documents, illegal offering of financial instruments and the breach of conduct rules. The harshest of these provisions relates to disclosure in prospectuses and similar documents. An intentional false information, an 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 of providing a prospectus or key investor document in the proper manner or an intentional failure to publish these documents within the deadlines prescribed by law. Whoever commits the above acts negligently will be subject to a fine of up to 180 daily rates (*Tagessätze*; i.e. as a function of the offender's income).

A false information does not have to be material in order 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 have incurred any damage as a result of false or misleading information in the disclosure document. In case of an intentional act or a mission, it seems that the intent must only relate to the false or misleading nature of information. This offence is consummated 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.

FIDLEG also sanctions certain offerings of financial instruments in breach of the proposed new legal provisions. For example, whoever offers 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 CHF 500'000 in case of an intentional act or a fine of up to CHF 150'000 in case of a negligent act. More importantly, 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 CHF 50'000 in case of an intentional act and up to CHF 15'000 in case of a negligent act.

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