Global Legal Insights

Banking Regulation

2019

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Switzerland

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Introduction

In the aftermath of the financial crisis of 2008/2009, Switzerland launched a massive overhaul of its financial regulations. These reforms followed several objectives. First, banking regulations were revised to ensure the stability of the financial system, in line with the recommendations of the Financial Stability Board ("**FSB**") and other international standard-setters. Second, Switzerland reacted to EU law in order to ensure equivalence and to be able to continue to access the European market as a third party state. Therefore, the reforms also aimed to align Swiss law with EU regulations Directive 2014/65/EU on Markets in Financial Instruments II ("**MiFID II**") and Regulation (EU) No 600/2014 on Markets in Financial Instruments ("**MiFIR**") to ensure Swiss financial institutions' access to the European financial markets. Finally, the reforms were geared to revising Swiss regulations from a patchwork of sectorial rules to a consistent regulatory framework.

The core of the new Swiss banking regulation will consist of the existing Federal Act on Banks and Savings Banks of 8 November 1934 ("**BankA**"), the existing Federal Act on the Swiss Financial Market Supervisory Authority of 22 June 2007 ("**FINMASA**"), the Financial Market Infrastructure Act of 19 June 2015 ("**FMIA**"), as well as the Federal Act on Financial Services of 15 June 2018 ("**FinSA**") and the Federal Act on Financial Institutions of 15 June 2018 ("**FinIA**"). The latter two are expected to enter into force on 1 January 2020 and will materially change the Swiss regulatory landscape. The changes will affect domestic financial service providers as well as foreign providers with a physical Swiss establishment, but – in a departure from the current regime – also foreign providers that pursue their Swiss business on a cross-border basis only. All of these players have to review the new regulatory requirements and adapt their business accordingly.

Banks in Switzerland have been facing pressure due to regulatory and legal developments. They have led to heavily increased reporting burdens. In addition, the tougher international capital and liquidity standards such as Basel III, issued by the Basel Committee on Banking Supervision ("**BCBS**"), or the new standards set by the FSB over the last few years, have led to increased costs of a bank's capital and long-term funding and other regulatory requirements including, e.g., new standards for resolution planning.

Besides these increased burdens, the major challenges currently lie in responding to strong competitive pressure, including from new entrants coming from the technology sector, and more transparency on fees. These challenges are aggravated by the continued low (including negative) interest rates and the strong Swiss currency, which together have resulted in declining profitability.

Furthermore, the current environment has been characterised by a variety of related legal

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developments, particularly in international tax matters. Switzerland implemented the automatic exchange of information based on the OECD CRS standard. In this context, the Federal Act on the International Automatic Exchange of Information in Tax Matters of 18 December 2015 ("**AEOI-Act**") entered into force on 1 January 2017, and the Federal Tax Administration for the first time exchanged information with partner states in September 2018. In addition, in the course of the implementation of the revised recommendations of the Financial Action Task Force ("**FATF**") and the Global Forum on Transparency and Exchange of Information for Tax Purposes ("**Global Forum**"), several laws have been amended and further reforms are under way. Since 2016, aggravated tax misdemeanours constitute a predicate offence for money laundering. Furthermore, the legal framework on anti-money laundering and anti-terrorism financing ("**AML**") has also become more stringent.

The accumulation of these factors has forced many banks to scale back some of their activities in Switzerland and consequently led to a trend toward consolidation in the Swiss banking sector in recent years. These tendencies toward consolidation are primarily seen with small banks and Swiss subsidiaries of foreign banking groups, while the latter in particular either close down their operations in Switzerland by liquidation or sale, or try to seek a critical mass of assets under management through acquisition or merger.

Despite this currently challenging environment, Switzerland is still a very attractive financial centre, as it combines many years of accumulated expertise, particularly in private banking and wealth management. In particular, the Swiss financial centre is the global market leader in the area of assets managed outside the owner's home country, with a global market share of 27.5% (see *Swiss Banking, Banking Barometer 2018: Economic trends in the Swiss banking industry*, August 2018, available at www.swissbanking.org). Professional advice, top-quality services and sophisticated banking products are the traditional strengths of Swiss financial institutions.

A good educational and training infrastructure, guaranteeing a reliable stream of qualified staff, political and economic stability, a flexible labour market and good infrastructure are also convincing arguments to build up Swiss banking presences. Moreover, the global position of Switzerland for currency trading has been further strengthened, since the Peoples' Bank of China authorised the Zurich Branch of China Construction Bank to act as a clearing bank for the Chinese currency Renminbi in November 2015.

Looking forward, Switzerland has positioned itself to become a hub for innovative financial technologies ("**Fintech**"). As part of this effort, the Swiss regulatory framework was adjusted to create an appropriate environment for Fintech providers. As a first measure, the Swiss Federal Council adopted amendments to the Federal Ordinance on Banks and Savings Banks of 30 April 2014 ("**BankO**") that entered into force on 1 August 2017 (see below). In addition, the Swiss Parliament amended the BankA to introduce a so-called Fintech licence as a new regulatory licence category, with less stringent requirements as compared to the fully-fledged banking licence, with effect from 1 January 2019. The Swiss Financial Market Supervisory Authority FINMA ("**FINMA**") has, furthermore, emphasised the technology-neutrality of the regulation and revised several of its circulars to specify the practice of the regulator under the current legislation.

Regulatory architecture: overview of banking regulators and key regulations

Responsible bodies for banking regulation

FINMA is the supervisory authority for banks, securities dealers and other financial institutions such as collective investment schemes and insurance undertakings. FINMA's

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primary tasks are to protect the interests of creditors, investors and policyholders and to ensure the proper functioning of financial markets. To perform its tasks, FINMA is responsible for licensing, prudential supervision, enforcement and regulation.

In parallel, the Swiss National Bank ("**SNB**"), the Swiss central bank, is responsible for monetary policy and the overall stability of the financial system. This includes the mandate to determine banks and bank functions as systemically important, in consultation with FINMA.

Under the so-called dual supervisory system in the banking regulation, FINMA largely relies on the work of recognised audit firms. As the extended arm of FINMA, these audit firms exercise direct supervision over financial institutions. They conduct regulatory audits of the banks on behalf of FINMA. In addition, FINMA may undertake targeted on-site supervisory reviews with the aim of achieving timely and comprehensive supervision. As an exception to the dual supervisory system, FINMA has a dedicated supervisory team which is responsible for monitoring directly UBS Inc./UBS Switzerland Ltd and Credit Suisse Group Ltd/Credit Suisse (Switzerland) Ltd., the two large Swiss banking groups. Furthermore, FINMA also increasingly takes "deep dives" in selected financial intermediaries to get a better understanding of the inner workings of supervised entities.

Key legislation or regulations applicable to banks

The key legislation for Swiss banks includes the following:

- the FINMASA defines the role and powers of FINMA;
- the Federal Act on the Swiss National Bank of 3 October 2003 defines the role and powers of the SNB;
- the BankA and the BankO provide for the general regulatory framework governing banks, including the banking licence requirements and accounting rules for banks;
- the Federal Act on Stock Exchanges and Securities Trading of 24 March 1995 ("**SESTA**") and the Ordinance on Stock Exchanges and Securities Trading of 2 December 1996 ("**SESTO**"), which are due to be repealed when the FinIA enters into force, contain, among others, i) rules on licence requirements for securities dealers, and ii) rules of conduct for securities dealers;
- the FMIA and the Ordinance on Financial Markets Infrastructures ("**FMIO**") contain, among others, i) licence requirements for stock exchanges, multilateral trading facilities, operators of organised trading facilities, central depositories, central counterparties, payment systems and trade repositories, ii) takeover and disclosure rules referring to listed companies, and iii) regulations on market conduct in securities and derivatives trading; and
- the FinSA, when it enters into force, will provide for rules of conduct for all financial service providers, including banks, as well as rules on prospectus and key information documents for certain financial instruments.

Further important regulations are:

- the Ordinance of FINMA on Foreign Banks in Switzerland of 21 October 1996 ("**FBO-FINMA**"), which provides for additional requirements for banks controlled by foreign persons as well as branches and representative offices of banks incorporated abroad;
- the Ordinance on Capital Adequacy and Risk Diversification for Banks and Securities Dealers of 1 June 2012 ("**CAO**");
- the Ordinance on Liquidity for Banks of 30 November 2012 ("**LiqO**"), governing capital adequacy and liquidity requirements applicable to banks and securities dealers;

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- the Ordinance of FINMA on the Insolvency of Banks and Securities Dealers of 30 August 2012 ("**BIO-FINMA**") governing the resolution and recovery as well as insolvency proceedings applicable to banks and securities dealers;
- the Federal Act on Collective Investment Schemes of 23 June 2006 ("**CISA**") and the Ordinance on Collective Investment Schemes of 22 November 2006 ("**CISO**") on investment funds and companies as well as rules on distribution;
- the Federal Act on Consumer Credit of 23 March 2001; and
- the AMLA and its implementing ordinances.

In addition, FINMA specifies its practice in numerous circulars. FINMA circulars as such are, in principle, not binding for Swiss courts but constitute a mere codification of how FINMA interprets and applies the applicable financial laws and regulations. However, the guidance of FINMA circulars might *de facto* have a binding effect for banks, since a violation may lead to regulatory sanctions.

Furthermore, the Swiss financial sector has a long tradition of self-regulation by self-regulatory organisations ("**SROs**"). Against this background, FINMA has recognised several self-regulatory guidelines and agreements of SROs as minimum standards, thus incorporating them within the regulatory framework and subjecting non-compliance to enforcement action (see FINMA Circular 2008/10 on "Self-regulation as a minimum standard"). An important example of self-regulation is the agreement on the Swiss bank's code of conduct with regard to the exercise of due diligence of 2016 ("**CDB 16**") by the Swiss Bankers Association ("**SBA**"), which defines know-your-customer policies that banks and securities dealers must apply. CDB 20, a revised version of CDB 16, will enter into force on 1 January 2020.

Influence of supra-national organisations and regulatory regimes or regulatory bodies

Switzerland is engaged in several international bodies, such as the FSB, the Bank of International Settlements (BIS), BCBS and the International Organization of Securities Commissions (IOSCO). Furthermore, Switzerland is a member of the FATF that sets out international standards in the area of AML and the Organisation for Economic Co-operation and Development ("**OECD**"), the Global Forum. Finally, although Switzerland is not a member of the G20, it has regularly been invited to participate in this international forum, which plays a leading role in defining international initiatives.

International standards have an increasing importance for Switzerland, as it has to ensure access for its financial institutions to foreign markets, and maintain a good reputation of the Swiss financial market overall. The standards established by supra-national organisations, including, e.g., FSB's Key Attributes of Effective Resolution Regimes for Financial Institutions dated 15 October 2014, and Guidance on Arrangements to Support Operational Continuity in Resolution dated 18 August 2016, have, thus, a strong impact on Swiss regulation in the financial sector. As a case in point, Basel III had a significant influence on the Swiss regulatory framework, such as the capital adequacy and liquidity standards specified in the CAO and the LiqO.

The Swiss regulatory framework is particularly influenced by developments in the European Union. As an example, the European Union harmonised its capital market regulation with MiFID II and MiFIR. Consequently, the Swiss legislator is following up and voluntarily harmonising certain aspects of Switzerland's legislation with similar provisions in the FMIA and FinSA, with the aim of ensuring access to the European financial markets (which requires, among others, a regulation that is equivalent to the EU regulation). Furthermore,

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the current revision of the Federal Act on Data Protection ("**FADP**"), which is likely to have an impact on several industry sectors, including the banking sector, aims to harmonise the FADP with the recently revised data protection regime of the European Union, in particular the General Data Protection Regulation (EU) No 2016/679.

The same also applies in the context of derivatives trading. The provisions on derivatives trading of the FMIA are significantly influenced by the respective provisions in the European Market Infrastructure Regulation (EU) No 648/2012 ("**EMIR**") and by rules of other international regulatory bodies: for example, FMIA implements the commitments assumed at the G20 summit in Pittsburgh in 2009, and adapts the Swiss regulation of the financial market infrastructures and derivatives trading to international requirements.

<u>Restrictions on the activities of banks</u>

A bank must obtain a licence from FINMA in order to operate in Switzerland, or from Switzerland to abroad. Switzerland follows a model of universal banking. Therefore, a bank is allowed to engage in any other business in the financial industry in addition to its deposit-taking business, if it has an appropriate organisation to carry out such activity, manages the operational risks and meets the requirements for fit and proper conduct of business. There are a few exceptions where an additional licence is required (e.g., if the bank acts as a securities dealer or as a depository of collective investment schemes). Moreover, a bank cannot operate a fund management company, an insurance company or a financial markets infrastructure.

A bank is required to describe in detail the scope of business (including the subject matter and geographical scope) of its activities in the licence application (and in the article of association and the organisational rules). Similarly, a securities dealer is required to describe in detail the scope of business activities in the licence application for a securities dealer (art. 10 SESTA). In case of any changes (in particular, an expansion) of the scope of the business activities of a bank or securities dealer, a bank or securities dealer respectively is required to inform and obtain prior approval of FINMA. Consequently, the scope of a banking and/or securities dealer licence is *de facto* individualised and, hence, varies from case to case.

In practice, it is, thus, fairly common for banks to be also licensed as securities dealers to provide a full range of banking services to their clients. Furthermore, many larger financial groups have separate entities engaging in fund management. By contrast, financial conglomerates, including both banks and insurance undertakings, are a relatively rare occurrence in Switzerland.

Recent regulatory themes and key regulatory developments in Switzerland

<u>New architecture of the Swiss regulatory framework</u>

The current Swiss regulatory framework is based on the so-called "silo-principle": the various financial institutions are, in principle, regulated in separate Swiss federal acts. For example, banks are primarily subject to the BankA (and BankO), securities dealers to the SESTA (and SESTO), and fund management companies and asset managers of collective investment schemes are subject to the CISA (and CISO). Similarly, the FMIA and FMIO, which entered into force on 1 January 2016, regulate financial infrastructures.

However, under the new regulatory framework of FinSA and FinIA that is expected to enter into force on 1 January 2020, financial institutions will be subject to a "cross-sectorial regulation". The FinSA aims to protect customers of financial service providers. It regulates

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the provision of financial services by financial service providers (including banks, securities firms, etc., to the extent they provide financial services, but not insurance undertakings) and the offering of financial instruments. It includes e.g.: regulation on client segmentation; rules of conduct; registration requirements for client advisors of financial service providers; rules on prospectus; and information leaflet requirements for financial instruments. In addition, the FinSA introduces the concept of a mandatory affiliation with an ombudsman office.

FinIA will regulate the licence requirements for certain financial institutions, including securities firms (under the current SESTA and SESTO, referred to as "securities dealers"), fund management companies, managers of collective assets, asset managers and trustees). In contrast, banks will remain subject to the regulatory requirements set out in the BankA (and BankO). Asset managers and trustees will be subject to a FINMA licence requirement but supervised by a FINMA authorised private supervisory body.

On 24 October 2018, the Federal Council initiated a consultation procedure for the three draft ordinances to implement FinSA and FinIA, namely the Financial Services Ordinance ("**FinSO**"), the Financial Institutions Ordinance ("**FinIO**") and the Supervisory Organisation Ordinance ("**SOO**"). The consultation procedure lasts until 6 February 2019. It is expected that the final versions of the ordinances will enter into force together with FinSA and FinIA on 1 January 2020. Upon the entry into force of FinIA and FinIO, the SESTA and SESTO will be repealed.

<u>Regulation of systemically important banks</u>

In the financial crisis of 2007-2008, the Swiss government had to bail out UBS AG, the largest Swiss bank, with a capital injection of CHF 6 billion and liquidity support from the SNB. Consequently, Switzerland decided to take a position as a forerunner in the global efforts to improve the resolution of systemically relevant institutions carried out under the *aegis* of the FSB.

The Swiss approach consists of a policy mix of stringent capital requirements, both on a risk-weighted and absolute (through a leverage ratio) basis, for ("**SIBs**") and liquidity ratios, as well as recovery and resolution planning by the financial institutions and FINMA, acting as a resolution authority. In addition to the standard capital requirements, Switzerland phased in the requirements regarding total loss-absorbing capital ("**TLAC**") to ensure that sufficient capital is available to finance the resolution of SIBs.

Unlike other jurisdictions, however, the Swiss framework did not impose explicit requirements on ring-fencing or bans on proprietary trading. By contrast, it relied on a carrot-and-stick approach. The stick consisted of a regulatory requirement imposed on SIBs to ensure that they can be resolved in an orderly manner without compromising their systemically relevant functions. At the same time, the regulator was empowered to grant discounts to SIBs who take additional measures to enhance their resolvability. This led the two global SIBs ("**G-SIBs**"), UBS AG and Credit Suisse Group AG, to restructure their corporate group to be controlled by a holding company, which is to serve as a single point of entry in resolution, to carve out their domestic business in a separate financial institution, and create dedicated service entities to ensure that the domestic business, which houses the core of the systemically relevant activity, can remain viable even if the group enters into resolution.

<u>Resolution stay and bail-in</u>

To facilitate the resolution of the SIBs, Swiss law was amended to grant FINMA the authority to order a resolution stay applying to all termination rights, and automatic termination clauses

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triggered by the commencement of resolution proceedings for a period of two business days (art. 30a BankA). To ensure the enforceability of these powers, all banks and securities dealers are required to take measures to ensure that agreements that are not subject to Swiss law and the jurisdiction of Swiss courts provide for the contractual recognition of a resolutions stay. However, whereas the resolution stay powers of FINMA extend to all agreements, FINMA determined that only certain financial arrangements needed to be covered by the contractual recognition (art. 56 BIO-FINMA).

Furthermore, FINMA was also granted the power to bail in or write off unsecured and unprivileged claims in connection with the approval of a resolution plan (art. 31 (3) BankA and art. 49 BIO-FINMA). However, unlike the resolution stay and the approach in the EU, Swiss law does not require a contractual recognition of bail-in powers. This is a testimony to the fact that FINMA relies more on capital requirements and, for SIBs, TLAC than on bail-in powers to carry out a resolution of financial institutions.

Fintech

To ease the Swiss regulatory regime for providers of innovative financial technologies (Fintech), including e.g. crowdfunding and crowd-lending, electronic payment services, robo-advice and crypto-currencies, the Swiss Parliament introduced the following three measures:

- Third-party monies accepted on interest-free accounts for the purpose of settlement of customer transactions do not qualify as deposits from the public (and therefore do not count towards a potential banking licence requirement) if the monies are held for a maximum of 60 days (instead of only seven days, as was the case before the amendment) (art. 5 (3)(c) BankO).
- Firms accepting deposits from the public or publicly offering the acceptance of deposits are exempted from the banking licence requirement as long as: i) the deposits accepted do not exceed CHF 1 million; ii) no interest margin business is conducted; and iii) depositors are informed, before making the deposit, that the firm is not supervised by FINMA and that the deposit is not covered by the depositor protection scheme (art. 6 (2) BankO). This exemption from the banking licence requirement is available to Fintechs as well as any other type of business that fulfils the requirements. It aims at creating an innovation space, a so-called "sandbox".
- The new Fintech licence – a licence with more lenient requirements compared to the fully fledged banking licence – was introduced by an amendment of the BankA with effect as of 1 January 2019. This regimes applies for institutions that hold deposits of less than CHF 100 million. Under this licence, the deposits may not be invested and no interest may be paid on them. If the customers are protected through additional safeguards, FINMA can approve a higher deposit ceiling on a case-by-case basis. The holders of a FinTech licence are neither subject to the depositor protection regime nor are they required to comply with the capital adequacy requirements under the CAO. Accounting is carried out in accordance with the Federal Code of Obligations ("**CO**"), which is a further relaxation compared to the rules for a bank. A notable further relaxation is the minimum capital requirements, which according to the BankO should amount to at least CHF 300,000 or 3% of the public deposits they hold, instead of satisfying the complex capital adequacy rules of the CAO. Further adjustments regarding corporate governance, risk management and compliance are also possible, although FINMA has not yet published how it will proceed. However, the requirement to be subject to the AMLA remains unchanged compared to the fully fledged banking licence.

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Implementation of the Basel III requirements

Switzerland has largely implemented the core requirements of Basel III in the CAO, the LiqO and various FINMA circulars. These requirements first applied exclusively to systemically important financial institutions, and were then extended to all banks.

Capital requirements: On 1 January 2017, the amended CAO entered into force, implementing the adjusted regulations of Basel III on credit risk capital requirements for derivatives, fund investments and securitisations for banks. The amendments introduced definitive rules on derivative positions *vis-à-vis* central counterparties and revised the capital requirements for all types of bank claims *vis-à-vis* all types of investment funds, as well as the capital adequacy rules on securitisation positions in the banking book. Along with the CAO, FINMA revised its Circular 2017/7 "Credit risks – banks" ("**Circular 2017/7**") introducing the implementing provisions. Further amendments to Circular 2017/7 entered into force on 1 January 2019 with regard to the calculation of the minimum capital requirements for the default fund of central counterparties to reflect additional changes made to the CAO.

On 1 January 2018, new rules introducing a leverage ratio and a new risk diversification provision in line with Basel III were introduced in the CAO. The changes included the introduction of an unweighted capital adequacy requirement based on the leverage ratio of 3% for all non-systemically important banks, and up to 10% for SIBs as an additional safety net. The provisions on risk diversification stated *inter alia* that risk concentrations may generally only be measured according to core capital (Tier 1) and that banks are restricted in their use of models for determining risk concentrations. Further changes concerned the overrun of the upper limits enshrined in the CAO, the weighting of certain assets, as well as the adjustment of some special rules for SIBs. To reflect the changes made to the CAO, FINMA revised its Circular 2015/3 "Leverage ratio – banks" ("**Circular 2015/3**"), which entered into force on 1 January 2018, as well as its Circular 2019/1 (formerly 2008/23) "Risk diversification – banks", which entered into force on 1 January 2019 and imposes a maximum limit on the size of individual loans as well as several relaxations for smaller institutions.

On 1 January 2019, further amendments to the CAO entered into force, introducing gone-concern capital requirements for domestically focused SIBs ("**D-SIBs**"; PostFinance AG, Raiffeisen and Zürcher Kantonalbank).

In connection with the requirements for managing interest rate risk in the banking book and standards on disclosure, FINMA further revised the following circulars: FINMA Circular 2011/2 "Capital buffer and capital planning – banks"; FINMA Circular 2013/1 "Eligible capital – banks"; Circular 2015/3, FINMA Circular 2016/1 "Disclosure – banks"; FINMA Circular 2019/2 "Interest rate risks – banks"; and Circular 2017/7. The changes introduce *inter alia* new disclosure tables as well as adjustments to the determination of eligible capital, which accommodate the treatment of expected credit loss provisions under the International Financial Reporting Standard (IFRS) 9.

The revised Basel III standards also entail new rules to determine the capital adequacy for market risks. In Switzerland, the new market risk rules are expected to enter into force on 31 December 2020 at the earliest.

Liquidity requirements: Under the LiqO (as in force since 2012), banks have to appropriately manage and monitor liquidity risks. It was thus possible to transpose part of the international liquidity standards of Basel III into Swiss law. In a further step, the revised LiqO, which entered into force on 1 January 2015, has also adopted the new quantitative liquidity

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requirements in accordance with the international liquidity standards. In particular, a liquidity coverage ratio (LCR) has been introduced for short-term liquidity, requiring banks to provide for sufficient high-quality liquid assets. A bank should, among other things, be able to survive for at least 30 days in the event of a liquidity stress scenario, with client deposits being withdrawn or difficulties with securing refinancing on the capital market. To reflect the changes made to the LiqO, FINMA revised its Circular 2015/2 "Liquidity risk – banks" ("**Circular 2015/2**"), which entered into force on 1 January 2018.

The amendments to the LiqO and Circular 2015/2 do not yet include provisions on the net stable funding ratio ("**NSFR**"), which must be implemented as a second minimal standard for the liquidity of banks. The Swiss Federal Council decided to defer the implementation of this new ratio at least until the end of 2019, because of substantial delays in the international timetable.

Administrative assistance

The implementation of the FMIA also entailed several changes in other areas, e.g. with regard to administrative assistance, where FINMA is not required to inform the relevant customer prior to transmitting the information to the requesting authority if the purpose of the administrative assistance and the effective fulfilment of the requesting authority's tasks were to be jeopardised by the prior notification (art. 42a (4) of the revised FINMASA, entered into force on 1 January 2016).

Automatic exchange of information and tax compliance

In response to the criticism of the Swiss financial centre, Switzerland adopted a "White Money Strategy", which led to the adoption of the automatic exchange of information in tax matters and extended the AML framework to taxation fraud. This strategy was heavily influenced by the recommendations of the FATF and the Global Forum in connection with international AML standards, as well as the pressure of the OECD to adopt the OECD automatic exchange of information in tax matters with countries abroad ("**AEOI**").

Against this background, a legal foundation for introducing the AEOI in Switzerland was created with the AEOI-Act that entered into force on 1 January 2017. Under the AEOI-Act, financial institutions subject to the AEOI-Act must collect specific data from 2017 onwards and submit it to the Swiss Federal Tax Administration which, in turn, exchanges the data with the tax authorities of the partner states. In view of the AEOI's activation with 38 states on 1 January 2017, Swiss financial institutions started to collect relevant data, and Switzerland exchanged data with most of the 38 partner states for the first time at the end of September 2018. In December 2017, the Swiss Parliament adopted the AEOI with a further 38 partner states. As a result, Swiss financial institutions have been collecting account information referring to further 38 partner states since 1 January 2018, and Switzerland will exchange it for the first time no later than September 2019.

Furthermore, the recommendations of FATF also influence the revision of the AMLA and prompted a first revision that came into effect on 1 January 2016, implementing, e.g., new regulations in connection with business relationships and transactions with politically exposed persons. Currently, a further revision is under way, proposing among others to explicitly oblige and to regularly check that the information is up to date. This would create a basis for the existing practice and codify case law. Furthermore, due diligence obligations for the provision of certain services relating to the establishment, management or administration of companies and trusts are proposed. The revised AMLA is expected to enter into force on 1 January 2020 at the latest. The country review of the FATF also led to an ongoing revision of the ordinance of the FINMA on Combating Money Laundering and

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Terrorist Financing in the Financial Sector of 3 June 2015 which addresses shortcomings identified in the FATF country review.

The Swiss Federal Council launched the consultation on the implementation of the recommendations of the Global Forum on 17 January 2018. The proposed text is currently being discussed in Parliament. The draft bill aims, in addition to change to corporate law, to facilitate the exchange of tax-related information.

Implementation of the Foreign Account Tax Compliance Act

On 2 June 2014, the agreement between Switzerland and the United States on cooperation to simplify the implementation of the Foreign Account Tax Compliance Act ("**FATCA**") entered into force. Under this agreement, the implementation of FATCA in Switzerland was based on the so-called "Model 2", which means that Swiss financial institutions disclose account details directly to the US tax authority, with the consent of the US clients concerned. However, in October 2014, the Swiss Federal Council approved a mandate for negotiations with the US on switching to "Model 1", which might lead to the application of the automatic exchange of information between Switzerland and the US. It is still unknown at the present time when there will be a corresponding agreement between Switzerland and the United States.

Bank governance and internal controls

Key requirements for governance of banks

In order to obtain and maintain a banking licence, Swiss banks must, *inter alia*, comply with specific governance requirements as outlined in particular in the BankA and BankO, and further specified in guidelines and publications of FINMA, in particular the new FINMA Circular 2017/1 "Corporate governance – banks" ("**Circular 2017/1**") which entered into force on 1 July 2017. It remains to a large extent in line with the former FINMA guidance, except for a number of changes in specific areas. A significant change introduced by Circular 2017/1 is a shift from a "comply or explain" approach to a more differentiated approach, allowing FINMA to apply the requirements of Circular 2017/1 to the extent they are proportionate. This allows FINMA to consider on a case-by-case basis the characteristics of each bank in terms of size, complexity, structure and risk profile.

Good reputation and guarantee of a proper business conduct

Persons entrusted with the bank's administration and management must enjoy a good reputation and guarantee proper business conduct (art. 3 (2)(c) BankA). Furthermore, qualified shareholders of a bank (i.e. persons holding at least 10% of the capital or voting rights or that otherwise have a significant influence on the bank) must guarantee that their influence will not have a negative impact on the bank's prudent and solid business activity (art. 3 (2)(cbis) BankA).

Separation of board of directors and executive management

The governance of Swiss banks is characterised by a strict separation between the board of directors, which is responsible for oversight, and the executive management.

A bank's board of directors as a body and each board member must meet specific conditions, including the following:

- To comply with the independence requirement, the board members have to structure their personal and business relationships in such a way as to avoid possible conflicts of interest with the bank. In particular, at least a third of the board members must be

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independent (Circular 2017/1 N 17 *et seq*.). FINMA may, in justified exceptional cases, grant exceptions. This might be relevant in financial groups, in particular.

- The board of directors as a whole must have adequate management expertise and the required knowledge and experience in the banking and financial services sector. It must be sufficiently diversified to ensure that all key aspects of the business, including finance, accounting and risk management, are adequately represented (Circular 2017/1 N 16).
- The board of directors must comprise at least three members. However, the actual number of directors required depends on the size, complexity and risk profile of the bank (art. 11 (1) BankO and FINMA explanatory notes to the draft Circular 2017/1 N 3.2.2) and, in practice, a board generally has at least five members.

Committees of the board of directors

The larger and more complex banks, which belong to the supervisory categories 1 to 3 (out of five), are required to establish an audit and a risk committee, irrespective of the total number of members of the board of directors. However, banks in the supervisory category 3 may combine the two committees (Circular 2017/1 N 31).

A majority of the members of both committees must be independent and the chair of the board of directors may not be a member of the audit committee or chair the risk committee. Furthermore, each committee must have sufficient knowledge and experience of the areas for which it is responsible (Circular 2017/1 N 33).

Internal audit function

The board of directors, in principle, has to establish an internal audit function that directly reports to the board or one of its committees, typically to the audit committee. The internal audit function works independently from the daily business processes and, in particular, provides an important basis for the assessment of whether the bank has implemented an adequate and effective internal control system (Circular 2017/1 N 82 *et seq*.).

Mandatory management functions

Banks in the supervisory categories 1 to 3 have to implement the role of an independent chief risk officer ("**CRO**"), who has to be a member of the management body if the bank is systemically relevant. Such CRO may be responsible also for other independent control functions (e.g. for the compliance function) even in the case of systemically relevant banks (Circular 2017/1 N 67 *et seq*.).

Remuneration of a bank's employees

As a general rule, a bank's remuneration system must not offer any incentives for an employee to disregard the bank's internal control mechanisms. In particular, the remuneration system for employees of the internal audit, the compliance function and the risk function may not contain incentives that could lead to a conflict of interests. Therefore, their remuneration (among others, through salaries and bonuses) may not depend on the performance of individual products and transactions.

The FINMA Circular 2010/1 "Remuneration schemes" ("**Circular 2010/1**") outlines minimum standards for remuneration schemes of banks and other financial institutions. In particular, it includes the requirement of a remuneration scheme to be simple, transparent, implementable, and oriented towards the long term. The Circular 2010/1 mandatorily only applies to banks of the supervisory category 1 (i.e. to UBS and Credit Suisse) and the two largest insurance groups, being Zurich and Swiss Re (see Circular 2010/1 N 6 and 7). However, it applies as a non-binding code of best practice to all other institutions. In

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addition, FINMA may in justified cases require such other institutions to mandatorily implement the Circular 2010/1 in full or in part, if appropriate in the light of the circumstances (Circular 2010/1 N 9).

On 1 January 2014, the Ordinance against Excessive Compensation of 20 November 2013 implementing the so-called "Say-on-Pay" Initiative entered into force, toughening the formal corporate governance regime for listed companies. Among others, it prohibits severance payments (golden parachutes), advance payments and similar extraordinary payments to directors or senior managers. Furthermore, the aggregate compensation of directors and the senior management is subject to the approval of the general meeting of shareholders. In the course of the ongoing revision of the company law, the Swiss Federal Council proposes to further implement the Minder Initiative by including provisions on "say-on-pay" in the CO.

Scope and requirements for outsourcing of functions

All significant functions of a bank may, in principle, be outsourced, except for the direction, supervision and control by the supreme governing body, central executive management functions and functions that involve strategic decision-making (FINMA Circular 2018/3). In addition, decisions on entering or terminating a business relationship may not be outsourced. Furthermore, banks of the supervisory categories 1 to 3 are required to have an autonomous control body in the form of a separate risk control and compliance function. Operational risk management and compliance tasks may be outsourced by banks of all supervisory categories. The bank must keep an inventory of the outsourced functions.

Furthermore, the bank, its audit firm and FINMA, must have the contractual right to verify the service providers' compliance by inspecting and auditing all information relating to the outsourced function at any time, unrestrictedly. Outsourcing to another country is admissible if the rights of inspection and control rights of the bank itself, its audit firm and FINMA are assured and the restructuring or resolving of the bank in Switzerland, including access to the required information, are possible at any time.

Accounting rules

Value adjustments for default risks in banking are to be calculated in future on the basis of expected losses. For this change, FINMA will draft a new ordinance on accounting which will also incorporate parts of the FINMA Circular 2015/1 "Accounting – Banks". The date of entry into force of this new ordinance is not yet known.

Bank capital requirements

In order to obtain a banking licence from FINMA, a bank must have a fully paid-in share capital of at least CHF 10 million (art. 15 (1) BankO). However, in principle, FINMA requires a bank to have additional capital of at least CHF 10 million but usually more (which might be contributed e.g. in the form of a subordinated loan as well), depending on the intended scope of the bank's business activities.

In addition to the statutory capital requirements, banks are also subject to regulatory capital requirements based on the Basel III Framework. The CAO specifies in more detail the regulatory capital required by Swiss banks, particularly depending on the bank's size and scope of business. The required capital comprises, in principle, the following parts:

- *Minimum required capital*: A bank must hold at least 8% of the risk-weighted positions as minimum required capital, whereof at least: i) 4.5% must be held in the form of common equity tier 1 (CET 1) capital (CET 1 ratio); and ii) 6% must be held in the form of Tier 1 capital (Tier 1 capital ratio) (art. 42 (1) CAO).

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- *Capital buffer*: A bank must, in principle, hold a capital buffer between 2.5% and 4.8% of their risk-weighted positions, in particular, in the form of CET 1 capital, depending on the supervisory category of the bank (art. 43 (1) and appendix 8 CAO; art. 2 (2) and appendix 3 BankO).
- *Counter-cyclical buffer*: Upon request of the SNB, the Swiss Federal Council may, if necessary, require the banks to hold a counter-cyclical buffer of a maximum of 2.5% of their risk-weighted positions in Switzerland in the form of CET 1 capital to: i) enhance the banking sector's resilience against the risk of excessive credit growth; or ii) counteract excessive credit growth (art. 44 CAO). Currently, the Swiss Federal Council has activated the counter-cyclical buffer to counteract the risk of a real estate bubble fuelled by cheap mortgage loans, and requires banks to hold a counter-cyclical buffer of 2% of their risk-weighted positions whereby a residential property in Switzerland acts as real security (in accordance with art. 72 CAO).
- *Extended counter-cyclical buffer*: Banks with a balance sheet of at least CHF 250 billion, of which the total foreign commitment amounts to at least CHF 10 billion, or with a total foreign commitment of at least CHF 25 billion, have to hold an extended counter-cyclical buffer in the form of CET 1 capital. This buffer amounts to the weighted average of the counter-cyclical buffers that apply in the member states of the BCBS where the bank's relevant receivables from the private sector originate, but in no case more than 2.5% of the risk-weighted positions (art. 44a CAO).
- *Additional capital*: FINMA may require a bank to hold additional capital if the minimum required capital and counter-cyclical buffer does not sufficiently cover the risks of a specific bank (art. 45 CAO).
- *Leverage ratio*: A bank must also maintain a 3% minimum leverage ratio based on the un-risk-weighted assets and Tier 1 capital (art. 46 CAO and Circular 2015/3).
- *Additional requirements for SIBs*: In addition to the above-mentioned requirements that apply to all banks, SIBs have to comply with additional requirements, e.g. they must have sufficient own funds to be able to continue their business activities even in the event of major losses (going-concern capital requirements), or they have to permanently hold additional funds to ensure a possible restructuring and winding-up (gone-concern capital requirements) (art. 124 *et seq.* CAO). G-SIBs are required to hold 100% of their going-concern capital requirement as TLAC. With effect from 1 January 2019, the gone-concern capital requirements also apply for D-SIBs. The new requirements are based on the going-concern capital requirements but, unlike for the big banks, this reflection amounts to only 40%, subject to further rebates for state-owned D-SIBs, as the domestically focused banks are less interconnected internationally and are less systemically important.

Rules governing banks' relationships with their customers and other third parties

<u>Regulations applying to the bank's dealing with third parties</u>

- *Banking and securities dealer activities*

In Switzerland, the primary law governing the relationship between banks or securities dealers and their clients is the private civil law laid down in the CO. In many instances, a banking or securities dealing relationship is subject to the principles of the law of mandate of the CO. Under such provisions, *inter alia,* an agent has to act faithfully and diligently (art. 398 (2) CO).

The nature of the legal duties owed by and customs of banks have been developed through court practice and by professional standards established by recognised SROs.

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Securities dealers must comply with the rules of business conduct outlined in art. 11 SESTA, including the duty to provide information, the duty of diligence and the duty of loyalty. This provision will be replaced by the provisions of FinSA. Furthermore, rules of SRO recognised by FINMA as minimum standard requirements applicable to certain financial institutions specify these duties. These self-regulatory rules include, among others, the Code of Conduct for Securities Dealers, the Portfolio Management Guidelines of the SBA.

- *Activities referring to collective investment schemes*

A bank responsible for the management of a collective investment scheme, the safekeeping of the assets held in it, or the distribution of it to non-qualified investors in Switzerland, is subject to licence requirements, and has to comply with the code of conduct requirements outlined in art. 20 *et seq*. CISA, including the duty of loyalty, the duty of diligence and the duty to provide information. These rules are further implemented through the self-regulatory standards set forth in the Code of Conduct of the Swiss Funds & Asset Management Association SFAMA, which is also recognised by FINMA as a minimum standard requirement.

- *Outlook: FinSA*

The rules of conduct applicable to financial service providers, including banks, are going to change fundamentally with the FinSA. Under this new legislation, financial service providers will be required to provide extensive information on themselves, the services and products they recommend, as well as the risks and costs they entail. Furthermore, depending on the type of client and service they offer, they will be subject to further requirements to ensure the suitability or appropriateness of their offering. The implementation of these rules will come together with extensive documentation and record-keeping obligations as well as organisational requirements. In particular, client advisors will need to have the requisite knowledge and expertise to comply with their duties under the rules of conduct and carry out their business.

<u>Rules applying to the general terms and conditions of banks</u>

The use of general terms and conditions ("**GTC**") to govern the relationship between the bank and its clients is widespread in the Swiss banking industry. However, Swiss law does not regulate the GTC of banks specifically. Accordingly, the question whether GTC are valid must be established on the basis of the Swiss private law, particularly the general contract law provisions of the CO and art. 8 of the Federal Act against Unfair Competition of 19 December 1986 (AUC) that prohibits the use of GTC that, to the detriment of consumers and contrary to the requirement of good faith, provide for a significant and unjustified imbalance between contractual rights and contractual obligations. Furthermore, specific regulations prohibit banks from including certain terms in their GTC with customers. For example, a right to use client securities may not be included in GTC. Against this background, the use of GTC might, in a typical business-to-customer relationship, be more limited in the banking industry.

<u>Mechanisms for addressing customer complaints against banks</u>

- *General remarks*

Under Swiss supervisory law, FINMA's mandate includes the protection of creditors, investors and policyholders. However, client protection is understood collectively and therefore FINMA does not adjudicate or even intervene in a dispute between a client and a bank. Furthermore, there are no explicit regulatory rules on handling complaints, although arguably the appropriate internal organisation of a bank requires the implementation of a complaints procedure.

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Disputes between a client and a bank are thus the remit of the ordinary courts, subject to the mediation by the Swiss Banking Ombudsman, if the bank is a member of the SBA.

- *Swiss Banking Ombudsman*

As part of its self-regulatory role, the SBA established a separate and independent institution, the Swiss Banking Ombudsman. Members of the SBA are required to submit to the authority of the Swiss Banking Ombudsman

The Swiss Banking Ombudsman is an independent and neutral mediator whose services are free of charge for the banking customer. He is competent to approach specific complaints raised by banking customers against banks based in Switzerland, but has no power to decide. Consequently, he mainly acts as a mediator in disputes to avoid costly and lengthy legal proceedings. The parties are not bound by his proposal but may choose either to accept it or to take other steps, such as starting a lawsuit.

- *Changes of the enforcement of client's rights according to the adopted FinSA*

In order to facilitate the enforcement of rights for banking clients, FinSA will introduce several changes to the enforcement of Swiss banking clients' rights, among others an extensive documentation duty that requires financial service providers to document their services in an appropriate manner, and a right of a client to request the delivery of copies of these documents free of charge.

Furthermore, financial service providers will be required to join an ombudsman's office, which will offer a simple and informal process to settle disputes between clients and financial service providers. For members of the SBA, however, this will not be a major change (see above).

More generally, the government announced that it is generally considering introducing a scheme for collective enforcement of claims in the Swiss Civil Procedure Code. This Swiss form of class action would not be limited to suits against banks and financial institutions but should be generally available for all types of civil disputes. This would further facilitate the enforcement of clients' rights and reduce the risk of high procedural costs.

<u>Swiss depositor protection scheme</u>

Deposits of Swiss banks are, in particular, protected by the following measures:

a) Client deposits of Swiss banks are, in principle, privileged claims in case of bankruptcy of a bank up to CHF 100,000 (art. 219 (4)(f) 2nd class of the Swiss Federal Act on Debt Collection and Bankruptcy of 11 April 1884 (DEBA) in conjunction with art. 37a (1) and art. 37b (1) BankA). However, the law further distinguishes between certain types of accounts. For example, deposits for vested benefit schemes are treated separately from other bank accounts and may benefit from the privileged status in an additional protected amount of up to CHF 100,000 (art. 37a (5) BankA).

b) Furthermore, client deposits of a bank or securities dealer located in Switzerland are protected to a maximal amount of CHF 100,000 per depositor. This depositor's guarantee in case of bankruptcy of a bank is ensured by the Swiss depositor protection scheme ("***esisuisse***") which requires that all Swiss banks and branches of foreign banks must have their preferential deposits protected by *esisuisse*.

c) Finally, client custody assets of Swiss banks and securities dealers are deemed by law, in principle, as segregated client assets. Consequently, they will be segregated in case of an insolvency of a bank or securities dealer (art. 37*d* BankA in connection with art. 36*a* SESTA).

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Furthermore, the Swiss Federal Council decided in February 2017 to strengthen the Swiss depositor protection scheme. The consultation process with respect to the amendment of the BankA is expected to start in 2019. The Swiss Federal Council also plans to close a gap in the regulations on investor protection: the obligation to segregate client holdings booked to client accounts from proprietary holdings shall be extended over the entire custody value chain in Switzerland.

Restrictions on inbound cross-border banking activities

The Swiss approach to inbound cross-border banking services is rather liberal. Banking activities on a pure cross-border basis only (i.e. without any actual or deemed local physical presence) from abroad into Switzerland are, in principle, not subject to a banking licence requirement. Consequently, a foreign banking institution may, in principle, freely offer banking services to Swiss-based customers if it does not establish a physical presence in the meaning of art. 2 (1) FBO-FINMA (i.e. a representative office or a branch) and does not inaccurately represent that it is based or regulated in Switzerland. However, this will change upon entry into force of FinSA, which will extend the scope of Swiss financial market regulation to activities carried out "for clients in Switzerland". In other words, providing financial services to clients in Switzerland on a cross-border basis will be subject to FinSA.

In contrast, the distribution of shares or units of collective investment schemes, and the placement of certain financial products in Switzerland, are subject to restrictions and licence or prospectus requirements. In particular, only Swiss-licensed representatives, holders of a FINMA distributor licence, or entities adequately licensed in their country of domicile to distribute collective investment schemes, may proceed with any form of distribution of collective investment schemes in Switzerland (art. 13 CISA).

Regulatory framework on AML

Money laundering is subject to criminal sanctions under art. 305bis of the Swiss Criminal Code of 21 December 1937 ("**SCC**"). Money laundering in the meaning of the SCC includes any act suitable to conceal or disguise the identification of the origin or impede the tracing or the forfeiture of assets that have been obtained through serious crimes and certain tax offences.

Prudentially supervised financial institutions, such as banks and securities dealers, as well as other persons or entities who, on a professional basis, accept or hold third-party assets or who assist in the investment or transfer of such assets, including activities such as (independent) asset management and certain types of credit/lending business, trade finance including factoring with right to recourse, payment services, trading activities, etc., are subject to additional regulatory requirements (art. 2 (2) and (3) AMLA). Financial intermediaries which are not otherwise regulated (e.g. by FINMA through holding a banking or securities dealer licence) have to join a recognised SRO which will review their compliance with Swiss AML rules on a regular basis (art. 14 AMLA).

A major part of the AMLA provisions deal with the due diligence duties in connection with a financial intermediary's handling of third-party assets including the due identification of the contractual party and the due determination of a potential beneficial owner, whereas, among others, these duties are further specified in the CDB 16.

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