Something Old, Something New: The Supervision of Financial Intermediaries under the Draft Federal Act on Financial Institutions

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On 4 November 2015, the Federal Council published a Bill to parliament for a Financial Services Act (FinSA) and a Financial Institutions Act (FinIA). As expected, the FinIA proposes to revise the regulatory architecture for financial institutions. Instead of the current sectorial approach, the FinIA proposes to introduce a regulatory pyramid with a light regulatory framework for asset manager and trustees, and an increasingly more stringent regime for collective asset, securities houses and, at the top, banks.

By Rashid Bahar (*Reference: CapLaw-2016-7*)

1) Regulatory Pyramid

On 4 November 2015, the Federal Council published a Bill to parliament for a Financial Services Act (FinSA) and a Financial Institutions Act (FinIA). As expected, the FinIA proposes to revise the regulatory architecture for financial institutions. Instead of the current sectorial approach, the FinIA proposes to introduce a regulatory pyramid with a light regulatory framework for asset manager and trustees, and an increasingly more stringent regime for collective asset managers, who manage collective investment schemes and pension funds, securities houses – the new denomination for securities dealers – and, at the top, banks. Following this approach, a more stringent license automatically carries the license to carry out the business of a less stringent entity. Banks will, thus, be allowed to carry out the business of entities with a less stringent license. More specifically, banks will be automatically authorized to engage in the business of a securities house, a collective asset manager, a trustee or an asset manager (article 5 (1) FinIA); securities houses will be authorized to manage assets of collective investment schemes and pension funds, act as asset manager and as trustee (article 5 (1) and (2) FinIA). Collective assets managers will similarly be entitled to engage in “simple” asset management (article 5 (4) FinIA).

The pyramid is, however, not complete, since it branches out for fund management companies: entities with a more stringent license, e.g. banks or securities dealers, will not be entitled to engage in fund management (article 5 (1) and (2) FinIA a contrario), although fund management will have carry the right to engage in the business of collective asset managers and asset managers (article 5 (3) FinIA). Similarly, only banks and securities houses will be automatically licensed to act as trustees. Fund management companies and collective investment managers will not be authorized to act as trustees although they hold a more stringent license (article 5 (3) and 5 (4) FinIA *a contrario*).

Moreover, the system will not be as elegant as several functions under the Collective Investment Schemes Act of 23 June 2006 (CISA, SR 951.31) will continue to require a specific license, even for banks. Thus banks will continue to apply for a specific license to act as a depository bank (article 13 (2) (e) CISA). Banks, securities dealers, and collective asset managers will also continue to need a specific license to act as representative of foreign collective investment schemes (article 13 (3) CISA and article 8 (1) and (3) of the Ordinance on Collective Investment Schemes of 22 November 2006, SR 951.311).

Finally, the Federal Council decided not to maintain the systematic approach of the FinIA. In response to the consultation proceedings, banks will continue to be governed by the Banking Act of 8 November 1934 (SR 952.0) and will not be integrated in the FinIA. At the same time, this is a pyrrhic victory for the opponents of an integrated regulatory framework: while the Banking Act will survive the FinIA, it will be overhauled and to a large extent aligned

with the provisions of the FinIA.

2) Licensing Requirements

a) Core Requirements

Under the FinIA, all institutions will be subject to common core requirements that they need to comply with. These requirements will be largely modelled on the current regime applicable to banks and securities dealers as applied by FINMA: all institutions will be required to have an appropriate organization (article 8 FinIA), including risk management and an effective internal control system (article 8 (2) FinIA). In line with the current practice of FINMA, both the institution as such and the members of the board of directors and executive management will be subject to a fit and proper requirement, which extends also to their reputation and professional qualifications (article 10 (1) and (2) FinIA). A similar requirement will apply to qualified shareholders (article 10 (3) FinIA), who will, as is currently the case, be subject to a duty to disclose their shareholding prior to reaching or crossing thresholds of 10, 20, 33 and 50 per cent of the shares or capital of a financial institution (article 10 (5) FinIA).

The FinIA, further, generalizes the rules of the CISA on outsourcing by permitting financial institutions to third parties only if they have the requisite skills, knowledge and experience and hold the requisite licenses to carry out their business (article 13 (1) FinIA). In this context, the FinIA empowers FINMA to condition the delegation of investment management to persons in other jurisdictions on the existence of an agreement between FINMA and the foreign regulator on cooperation and exchange of information (article 13 (2) FinIA).

Finally, all financial institutions will be required to join an ombuds-organisation upon starting their business (article 15 FinIA). This requirement ensures the effectiveness of the rules on alternative dispute resolution for investor disputes provided for by the FinSA.

b) Specific Requirements

In parallel, each type of institution will be subject to specific requirements. As the institutions raise in the regulatory pyramid, they become increasingly stringent: Asset managers and trustees are subject to fairly limited specific requirements: they will need to have either post collateral or a professional liability coverage (article 19 FinIA).

Collective asset managers will be subject to fairly straightforward organizational requirements, which focus on the delegation of duties (article 23 FinIA). They will not be subject to full capital adequacy and liquidity requirements. Instead, they will be expected to maintain a certain level of capital, post collateral or subscribe a professional insurance policy (article 24 FinIA) as well as minimal capital requirements. However, rules for consolidated supervision requirements kick in at this stage (article 26 (1) FinIA).

Securities houses and banks remain fundamentally subject to the current regime, including in terms of consolidated supervision. They are subject to full capital adequacy and liquidity requirements imposed by Basel III at entity and on a consolidated basis (article 42 FinIA). The flip-side of this regime is the possibility offered to banks and securities dealers to rely on additional capital instruments to prevent or overcome a situation of financial distress (article 43 FinIA and article 13 (1) Banking Act).

This being said, the FinIA introduces some novelties: for example, securities houses will be authorized to accept public deposits in connection with the settlement of securities trades (article 40 (1) and 2 FinIA) and credit such deposits to interest-bearing accounts, although they will probably not be allowed to advertise this aspect of their business (article 40 (3) FinIA) since the permission to accept deposits for settlement accounts does not extend to advertising for such services (article 43 (2) FinIA). This regulatory framework falls, however, short from an English-style client-money protection regime, although the FinIA mandates the Federal Council to issue provisions on the use of public deposits.

3) Supervision of Asset Managers and Trustees

a) Scope

In this context, the key novelty of the FinIA is the licensing requirement of asset managers and trustees. The former are defined as persons, who manage in a professional capacity on the basis of an asset management agreement assets of third parties in the name and for the account of clients (article 16 (1) FinIA), whereas the latter are defined as persons who act as trustees in connection with a trust within the meaning of the Hague Convention on the Applicable Law and the Recognition of Trusts of 1 July 1985 (article 16 (2) FinIA). Both will be subject to a similar regulatory regime implying a license, which will be granted provided the applicant complies with the common core requirements and the fairly limited specific requirements.

b) Exemptions

The scope of the business of asset managers and trustees is fairly broad and could subject numerous market participants to choose between seeking a license or limiting their activity to investment advice. Other participants will look to apply one or the other exemption to the FinIA. Indeed, the FinIA explicitly claims not to apply to persons exclusively managing assets of related parties or funds provided in connection with an employee participation plan (article 2 (2) (a) and (b) FinIA).

Moreover, the act does not apply to lawyers and notaries who act within the realm of their "typical" duties, namely within the realm of their function as legal counselor or notary rather than an atypical function as director or asset manager of a client (article 2 (2) (c) FinIA). More generally, the act does not apply to persons managing funds pursuant to a statutory mandate, such as guardians or other public officials (article 2 (2) (d) FinIA). In all these cases, the statute and professional ethics standards act as a sufficient control to protect investors.

Furthermore, other regulated institutions, such as pension institutions (article 2 (2) (f) FinIA), insurance companies (article 2 (2) (h) FinIA) as well as social security insurances and compensation funds (article 2 (2) (g) FinIA) will remain out of the scope of the FinIA. As such they will not be subject to the licensing requirements set forth by FinIA and will continue to be able to offer such services without seeking a dedicated license.

c) Licensing and Supervisory Authority

Following the consultation process, the Federal Council opted to regulate asset managers and trustees through one or more supervisory authorities rather than submitting them to the oversight of FINMA. The supervisory authorities will, however, be licensed and supervised by FINMA (article 43a (2) of the Financial Markets Supervisory Authority Act of 22 June 2007, FINMASA, SR 956.1, as amended by the FinIA). Unlike the self-regulatory authorities in charge of implementing the anti-money laundering rules, the supervisory authorities under the FinIA will be treated as fully-fledged governmental authorities under the Administrative Procedure Act of 20 December 1968 (APA, SR 172.021).

They will be empowered to take most actions that are currently reserved to FINMA: ranging from requesting information (article 29 *cum* article 43*p* FINMASA as amended by the FinIA), issuing declaratory rulings (article 32 *cum* article 43*p* FINMASA as amended by the FinIA), ordering any measure necessary to reinstate an orderly situation (article 31 *cum* article 43*p* FINMASA as amended by the FinIA), naming-and-shaming wrongdoers (article 34 *cum* article 43*p* FINMASA), and even confiscating undue profits (article 35 *cum* article 43*p* FINMASA as amended by the FinIA). While the supervisory authorities will be authorized to ban traders and client advisers (article 33a *cum* article 43*p* FINMASA as amended by the FinIA), their powers will stop short from issuing such orders against directors and executive managers (article 33 FINMASA *cum* article 43*p* FINMASA as amended by the FinIA *a contrario*). Similarly, it seems that the supervisory authorities will not be entitled to appoint a special investigator (*Untersuchungsbeauftragte*) for fact finding or administering an asset manager or a trustee (article 36 *cum* article 43*p* FINMASA as amended by the FinIA *a contrario*).

Conceptually, the supervisory model will be mirrored on the one currently applicable to banks and securities dealers:

rather than auditing investors directly, the FinIA proposes to allow a supervisory authority to require supervised institutions to appoint an auditor whose function would be to review the institution's compliance with the requirements of the FinIA (article 43*n* FINMASA as amended by the FinIA). However, rather than an annual audit enhanced by additional audits, the FinIA proposes to reduce the audit cycle to every three years and requiring supervised institutions to self-certify compliance when no assurance was provided.

4) Registration of Advisers of Investment Advisers and Foreign Financial Service Providers

The scope of the FinIA does not mirror the scope of the Draft Federal Act on Financial Services (FinSA). Thus, certain activities subject to the FinSA will not be carried out by licensed financial institutions. As mentioned above, certain regulated entities will continue to be able to offer their portfolio management services. Even if they are not subject to the FinIA, they will remain subject to regulatory oversight by their supervisory authority. At the other end of the spectrum, certain types of financial services, e.g. investment advice, remain unregulated.

To close the gap, the FinSA introduces a toned-down version of its obligation to register all client advisers: it suggests to subject client advisers working for investment advisers as well as advisers from foreign financial service providers to a registration requirement (article 30 FinSA). As with supervisory authorities, the register would be maintained by a private organisation acting under a public mandate (article 33 (1) FinSA) and will therefore be subject to the Administrative Procedure Act (article 36 FinSA). However, the function of the register would be limited to ascertain that the applicant satisfies the requirements to be registered without subjecting it to the ongoing supervision. Even then, a register will be required to de-register any financial intermediary who would no longer satisfy the registration requirements (article 34 (2) and (3) FinSA), e.g. if they committed an offence under the FinSA or more generally any offence against property under the Criminal Code of 21 December 1937 (CPS, SR 311.0).

5) Conclusion

Overall, the FinIA falls short from its ambition of introducing a comprehensive and systematic regulation of financial intermediaries. Arguably, this goal is not justified: while the same business should be subject to the same rules; many financial intermediaries are not involved in the same business.

On the substantive level, the FinIA aims to close an important gap in the regulatory regime: the lack of licensing requirement for asset managers. The approach it proposes, which relies on supervisory authorities licensed by FINMA to exercise prudential supervision, seeks to strike a balance between the existing regime which relies on self-regulation at the industry-level and government supervision. The reliance on two different regulators to license, supervise and enforce the regulations will lead to varying practices. The challenge will, therefore, be for FINMA as the direct prudential supervisor for collective asset managers, fund managers, securities house and banks and, through its role as supervisor of the supervisory authorities, indirect supervisor of asset managers and trustees, to ensure that the law is applied consistently while accounting for the complexity and specificities of each type of organisation.

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