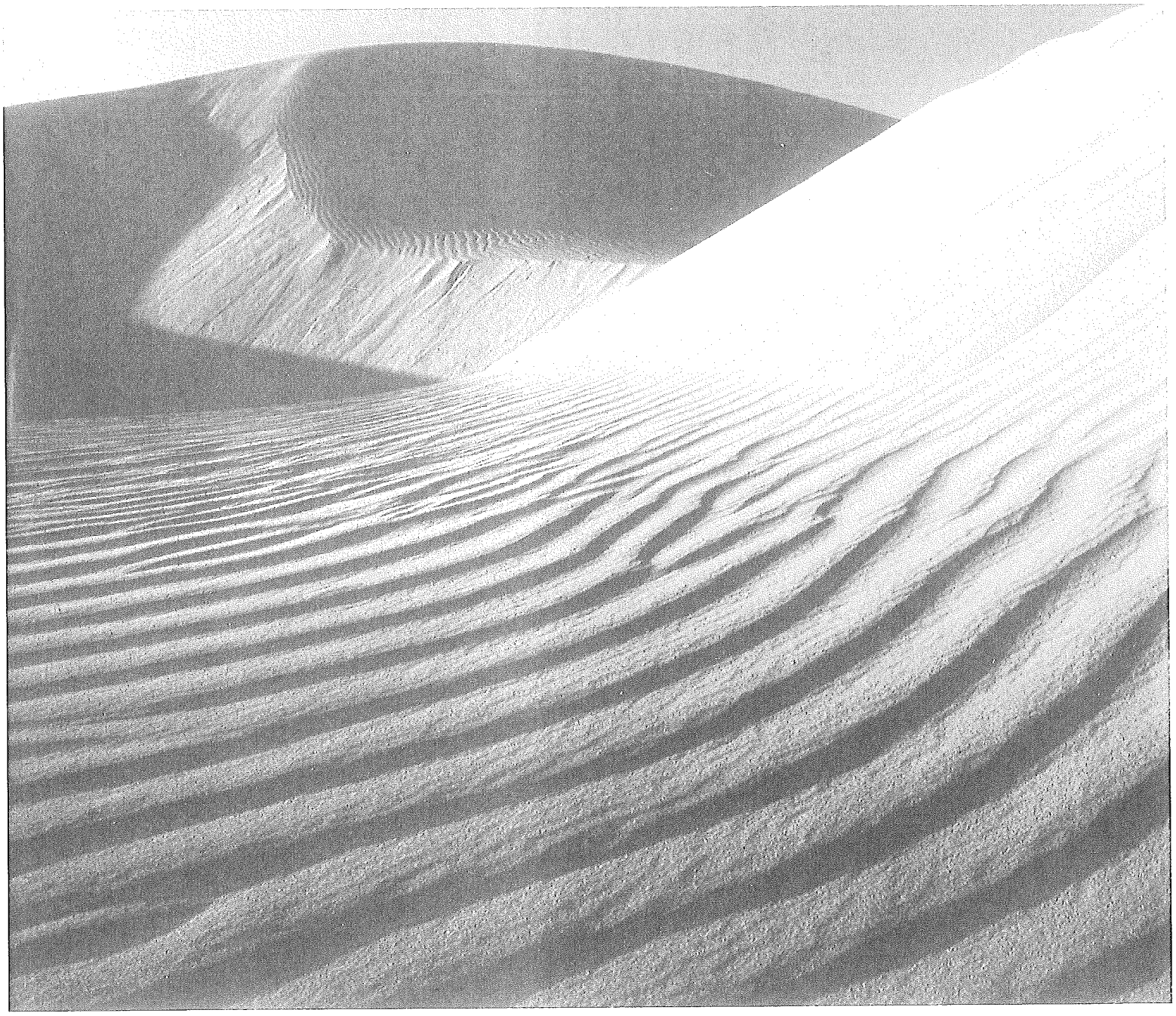

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A changing landscape

Regulatory developments in the distribution of retail investment products

UK, France, Germany, Spain, Italy, Netherlands, Switzerland, Russia, Hong Kong and the UAE

Second edition

Switzerland

1. What types of regulatory action (including enforcement, thematic reviews etc) and litigation have occurred in the past from failings in the distribution of retail investment products regime?

During the course of 2009 and 2010, there have been a number of regulatory enforcement actions and thematic reviews, and civil litigation concerning the distribution of retail investment products. These concerned in particular, mis-selling and/or incorrect investment advice, most prominently in connection with the Madoff fraud and Lehman Group products.

Madoff fraud and distribution of Lehman Group products – implications for investment advisory and asset management business

The Swiss Financial Market Supervisory Authority (FINMA) completed two large-scale thematic reviews in early 2010. The first concerned the impact of the Madoff fraud on Switzerland as a financial centre. The second looked at the distribution by Swiss financial intermediaries of structured products that were issued or guaranteed by subsidiaries of Lehman Brothers Holdings Inc. Both reviews confirmed that investors suffered extensive losses, paying for risks that were or could have been known, but were initially widely perceived as negligible.

"Qualified investors" made up the bulk of those affected by the Madoff affair, given that investment funds open for public distribution would not normally have invested in Madoff products, or, if so, due to diversification rules, would have done so to a very limited extent. "Qualified investors" are defined by article 10 paragraph 3 of the Swiss Federal Act on Collective Investment Schemes (CISA) and include retail investors as high net worth individuals where they have net bankable assets of over 2 million Swiss Francs. However, many non-high net worth retail clients were also affected by the bankruptcy of the Lehman Group, in that many had bought capital-protected structured products issued or guaranteed by the Lehman Group, to some extent, on the basis of advice given by banks and other financial intermediaries, or on their own initiative or without advice.

FINMA's review also found that investments in Madoff structures gave rise to questions about the correct level of due diligence required when investing in hedge funds etc, pursuant to discretionary mandates and advisory relationships, and to possible conflicts of interests for example in relation to trail fees. However, it was also found that reputed institutions rarely advised clients to invest in Madoff structures, or made such investments under discretionary mandates.

The impact of Lehman Group's bankruptcy on Switzerland caused the almost total loss of value of "capital-protected" structured products issued within the Lehman Group. FINMA's review found that the identity a product's issuer, was not generally a decisive factor in a client's investment choice and that clients did not tend to differentiate between issuers with comparable ratings or consider the risk of insolvency. The review also found that a number of investors had run massive concentration risks, which was a cause of concern for FINMA.

FINMA found that the lack of a requirement for issuers of non-listed structured products to issue simplified prospectuses before the date of issue, ie, before clients usually make their investment decisions, had caused problems, particularly given that clients normally did not request such prospectuses before they were available. This was a particular problem given FINMA's finding that structured products were very often sold in the primary market, ie, between the date of publication of the offer and the actual issue. FINMA however concluded that as a matter of principle capital-protected structured products are suitable for distribution to retail client.

Individual enforcement action

As a result of FINMA's above-mentioned reviews, a number of formal investigations were carried out against individual banks in respect of Madoff investments and the distribution of Lehman Group "capital-protected" structured products.

Increase of civil litigation

2009 and 2010 saw an increase in civil litigation instigated by investors against banks and independent investment managers. Cases in connection with alleged mis-selling or incorrect advice in relation to Lehman Group products gained most publicity, followed by disputes about whether, and subject to what conditions, retrocessions should be forwarded to investors (such cases related to regulations in existence before the new regulatory rules on transparency on retrocessions came into force – see below).

Repurchase and reverse repurchase transactions and securities lending and borrowing transactions - FINMA Circular 2010/2

On 30 June 2010, FINMA Circular 2010/2 on repurchase and reverse repurchase transactions and securities lending and borrowing transactions came into force. The circular states that uncovered securities lending and borrowing transactions are only permitted to be entered into with "qualified investors" (which as mentioned above may include retail clients), in accordance with article 10 paragraph 3 CISA. The circular also puts in place strict transparency requirements in relation to repurchase and reverse repurchase transactions and securities lending and borrowing transactions. The circular also stipulates how securities lending and borrowing transactions should be

treated under the current liquidity regulations. In addition, the circular contains detailed requirements on disclosure, the content of master agreements, and on processing and settlement, which aim to protect parties engaged in securities lending and borrowing transactions.

The circular states that banks and securities dealers which engage in securities borrowing transactions in the capacity of a counterparty, or which broker such transactions in the capacity of agents, must make advance disclosures to the clients (lenders) about the risks associated with individual transactions in a form that is easy to understand. Knowledge of the disclosures must be documented separately or in the securities lending and borrowing contract. The circular explains in detail which matters clients should be informed of.

Transitional rules apply to certain rules with regard to existing securities lending and borrowing transactions, until 31 December 2010.

2. What are the key aspects of the current regulatory regime for distributors of investment products to the retail market?

(1) What, if any, restrictions are there in relation to financial advisers describing their services as independent?

In Switzerland, there are no specific legal provisions or restrictions which regulate when the term "Independent" can be used by distributors of investment products to the retail market.

(2) What product disclosure requirements are in place?

Generally required disclosure at the point of sale

The Swiss Federal Act on Stock Exchanges and Securities Trading (SESTA) requires securities dealers to inform clients about the risks associated with certain types of transactions and investments. The Swiss Bankers' Association has issued a publication which contains information about these risks. This obligation is dependent on the client's level of experience and specialist knowledge in the area concerned. Clients must be informed about risks in relation to transactions that entail high levels of risk or have a complex risk profile, but not about specific risks relating to individual transactions. These rules do not, as a matter of principle, distinguish between various types of products (in contrast to the below).

Structured products

Structured products which are authorised to be offered publicly in or from Switzerland can only be distributed where they are issued, guaranteed or distributed by specific categories of entities, and where a simplified prospectus is available which complies with the following requirements:

- it must describe, in accordance with the standard format, the key characteristics of the structured product (key data), its profit and loss prospects, together with the significant risk for investors;
- it must be easily understood by the average investor; and
- it must make reference to the fact that the structured product is neither a collective investment scheme, nor requires the authorisation of FINMA.

Mutual funds and other collective investment schemes

Investors are required to be provided with certain documents (as approved by FINMA) depending on the type of fund vehicle. For example:

- Investment funds: the collective investment contract.
- SICAVs and SICAFs (types of open-ended collective investment scheme): the articles of association and investment regulations.
- Limited partnerships for collective investment: the company agreement.
- Foreign collective investment schemes: the relevant documents such as sales prospectus, articles of association or the fund contract.

Public offerings of shares and bonds

If an equity or debt offering is made by an issuer without a concurrent listing in Switzerland, the information documents disseminated to investors in connection with the offering are not subject to filing with, or approval by, any Swiss regulatory or self-regulatory authority. In Switzerland, unlike many other jurisdictions, shares and bonds can be offered to the public on the basis of a prospectus that has never been vetted by a local regulator. Public offerings of new shares or bonds by Swiss companies are, however, subject to requirements to disclose certain information in prospectuses as set out in article 6529 and 1156 of the Swiss Code of Obligations.

(3) What restrictions exist in relation to how clients are charged?

As a matter of principle, Swiss law does not contain any specific restrictions on how clients may be charged for investment products and services, subject to certain specific exemptions in respect of collective investment schemes. However, a number of rules and guidelines exist in relation to the disclosure of charges, retrocessions being dealt with appropriately, and conflicts of interest not causing investor detriment.

For example, the Portfolio Management Guidelines issued by the Swiss Bankers' Association state that in relation to discretionary investment management mandates, the method

and elements of a bank's charges must be agreed with the client in writing. Banks must also agree who will be entitled to any third party payments or commission that may be received in connection with, or at the time of executing, asset management agreements. Banks must disclose how such payments are calculated, or the scope of such payments, in relation to individual products or product classes. Banks may combine individual products into product classes, and are free to define product classes as they see fit. Disclosure obligations may be satisfied by the publication of: fact sheets and securities account statements or information via the internet. Banks are also obliged to inform clients of any conflicts of interest arising from the receipt of payments from third parties, and to put in place structural measures to avoid clients being put at a disadvantage from any conflicts of interest.

(4) What requirements are in place to ensure that products are suitable for clients?

Swiss law does not impose a general duty on providers of financial products and services to ensure that investments are suitable for clients. There are, however, specific rules in relation to execution-only clients (ie, where the client does not receive any type of advice or recommendation), advisory relationships, and discretionary investment management mandates.

In relation to execution-only clients, a bank's duty to provide information to clients (the extent of which may vary subject to certain conditions), does not extend to an obligation to ensure that investment products are suitable.

With regard to advisory relationships, there are currently no regulatory rules imposing suitability obligations. However, Swiss case law has established that providers of investment advice (note that providing a product recommendation may amount to investment advice) could be subject to an extensive duty to assess whether recommended investments are appropriate and, in certain situations, suitable for the client. The fact that these duties are currently only contained in case law is an area of concern for both the FINMA and investment advisers. It is therefore hoped that FINMA will clearly define investment advisers' duties at the point of sale.

In relation to discretionary investment management mandates, the situation is much clearer. Self-regulatory rules issued by the Swiss Banking Association such as the Portfolio Management Guidelines expressly contain a duty to clearly establish whether an investment is suitable for a client, consistent with established academic doctrine. Banks are obliged to discuss the investment objectives directly with the client and maintain appropriate records. Further, FINMA's Guidelines on Asset Management (Circular 2009/1) sets out obligations on asset managers, which include a duty of loyalty, the exercise of due diligence and disclosure obligations. With respect to the exercise of due diligence, in particular, asset managers must ensure that investments are always in line with the client's investment objectives and restrictions. Asset managers must review the investment strategies employed on a periodical basis and must ensure adequate risk diversification etc.

(5) Are investors entitled to any prescribed cancellation periods?

When purchasing investment products, investors are not entitled to any prescribed cancellation periods. This is subject to certain exemptions applicable to insurance products, "door-to-door transactions" and similar contracts.

3. Reform

(1) What domestic reforms have been proposed in this area?

FINMA project on new distribution rules

Following the findings of FINMA's thematic reviews and investigations regarding the Madoff fraud and Lehman Group as discussed above, FINMA came to the conclusion that existing legislation and regulation does not adequately protect investors or adequately balance the rights and obligations of providers of investment products and services on the one hand, and retail investors on the other. FINMA therefore believes that a review of the supervisory and legal framework in relation to investment product intermediation is needed. Accordingly, FINMA launched a "Distribution Rules" project to conduct a cross-sector examination of the existing distribution rules. On 10 November 2010 a discussion paper was published with a view to promoting dialogue to enhance the protection of clients when financial products are bought and marketed.

The focus of the reforms is on improving the rules of business conduct when marketing financial products, and on increasing client information. FINMA believes that whilst the law at present addresses certain problem areas in some respects, it does not do so adequately. For example, the law merely imposes isolated duties to obtain and provide information, and on the disclosure of: costs and of an institution's own interests and conflicts of interests. In FINMA's view, it is also inequitable that some financial services providers are not currently subject to any registration requirements and are able to provide their services entirely free from any supervisory standards. Another finding was that transparency regarding financial products also needs to be improved at product level. Prospectuses for investment products should also make clients aware of the material risks.

The following areas are presently being scrutinised with a view to reform:

- Improved documentation requirements at the point of sale by expanding duties to produce a prospectus and notification duties at product level.
- Rules of business conduct in client contact at the point of sale should be strengthened and harmonised.
- Comprehensible descriptions of the risks associated with financial products.

- Stricter and more consistent regulation of the cross-border distribution of foreign financial products in Switzerland.
- Adopting client segmentation with simpler product rules and rules of conduct for business with qualified clients.
- Bringing in rules of business conduct and a registration requirement for not prudentially supervised financial services providers at the point of sale.
- Binding, simple and fast settlement of disputes with retail clients by bringing in an ombudsman's office with the power to make ruling for all financial services providers.

Drawing on the results of the discussion paper, FINMA will look in considerable depth at the matters raised, and will ensure compliance with existing regulations if necessary by means of enforcement. FINMA has also proposed a general Financial Services Act to implement the reforms proposed.

(2) What are the key issues and implications?

The ensuing reforms will be likely to result in the need for firms to introduce amendments to how investment products and services are offered and sold, the main focus being at the point of sale (rather than on the production side).

(3) What is the timescale for implementation?

The deadline for comments to FINMA's discussion paper was on 15 April 2011. The past indicates that it may take several years before legislative measures come into force. It would be faster to implement a Federal Council ordinance on rules of business conduct in securities trading and the distribution of collective investment schemes, even though this would be limited to certain financial services providers already subject to prudential supervision.

(4) What can firms do in preparation for implementation?

Once key details of the proposed reforms are known, financial institutions should engage in the consultation process and consider the likely impact of the reforms on their business models.

4. Consumer redress

(1) What are the current domestic mechanisms for consumer redress?

Swiss Banking Ombudsman

The Swiss Banking Ombudsman is an independent body which mediates complaints against banks based in Switzerland free of charge. Since the Ombudsman's establishment in April 1993, the office has dealt with an increasing number of enquiries and complaints (currently about 1,400 a year).

The financial markets crisis dominated complaints during 2009. During this second year of the crisis, the volume of cases submitted for mediation has reached a record level. This year, a total of 4,757 cases were submitted for mediation, which represented a further increase of almost 15% compared to the previous year which already had a considerably higher than usual volume of cases. Given that the predominant number of cases concerned savings products (ie, absolute return investments) and capital protected products issued by Lehman Brothers, comparing data in categories of banking transactions with previous years, should be done with caution.

At present, there is no other body with dedicated jurisdiction to consider retail complaints against other types of financial institution. Consumers may lodge complaints with FINMA, although it is not under an obligation to consider them. As noted above, FINMA has proposed the establishment of an ombudsman with jurisdiction over all financial services providers, so as to provide for a binding, simple and fast mechanism for the settlement of disputes involving retail clients.

Class actions do not exist in Switzerland.

The revised Lugano Convention on jurisdiction and the enforcement of judgments in civil and commercial matters took effect in Switzerland on 1 January 2011. The Lugano Convention determines the international jurisdiction of the courts of signatory states. It also ensures that judgments from one signatory state are recognised and enforced in the other signatory states. The most important innovation relating to the revised Lugano Convention is the extension of its territorial scope to the new EU member states. The revised Lugano Convention will also have a bearing on courts' powers to review contracts between financial institutions and clients from Lugano Convention member states. This will enable clients to take legal action in their home country where the bank has "directed" its services to that country or member state. The precise definition of the term "direct" still needs to be elucidated by case law.

(2) Are there any domestic reforms in the pipeline to improve consumer redress?

There are no substantial reforms pending.

This chapter was contributed by Niederer Kraft & Frey AG, (who is not part of the Herbert Smith LLP Alliance).