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Switzerland

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Introduction

A conjunction of several events, not all related to the financial crisis, have induced noticeable changes in the regulatory, legal and political framework of Switzerland's financial sector in the last few years, the consequences of which have not yet fully unfolded. Beyond rescue operations, such changes cover the anticipation and reduction of systemic risks, and an increased level of transparency regarding financial products, rules of conduct and improved client protection.

The presence in Switzerland of two key institutions in the global banking sector (i.e., UBS AG and Credit Suisse Group AG), in addition to being systemically important for the Swiss economy, has required intense scrutiny from the Swiss Financial Market Supervisory Authority-FINMA (the "**FINMA**"), the Swiss Federal Government and the Swiss National Bank, in concerted initiatives to take emergency measures and address the regulatory and supervisory concept of "Too Big To Fail" – which in future will not necessarily be limited to the banking industry (see insurance companies and other financial market actors).

At the same time, since the end of 2007, various investigations had the potential to unsettle the Swiss financial system: the first was led by several US authorities into UBS AG, and then a few other Swiss banks which provided advice to individual US clients, thus entailing breaches of US securities and tax laws, bringing the threat of criminal charges. The escalating international pressures resulting from judicial and political differences and conflicting legal systems have resulted in far-reaching developments: (i) on the regulatory level, the re-assessment of legal risks associated with cross-border activities for Swiss institutions advising private clients abroad; and (ii) on the legal level, the confrontation between the Swiss banking regulation protecting the confidentiality of clients' personal data, and the growing pressure of foreign political and judicial authorities advocating an increased exchange of such information between tax authorities – thus raising issues linked to the legal (or moral) definition of tax avoidance or tax optimisation. Owing to the importance of non-domestic activity for the Swiss financial sector, cross-border good practices and the monitoring of the related legal risks (tax, criminal and civil law, reputation risk) have clearly gained in importance.

Over the last few years, increased levels of capital and prudential requirements, combined with a trend of decline in earnings derived from asset management and advisory activities, have led to a decline in the number of applications for bank and securities dealer licences. Smaller banks tend to withdraw from activities requiring a licence, and foreign groups may either concentrate on their domestic core business and scale down or close their operations in Switzerland, or seek a critical mass of assets under management through mergers. The FINMA indicates that about 70 banks and securities dealers exited the market over the last four years as a result of mergers, surrender of licences or cessation of activities.

There are no signs that this trend of consolidation in the asset management industry has ceased. In addition, the much-publicised discussions around the evolution of the duty for Swiss banks to protect the confidentiality of their clients' personal data, embedded in the Banking Act (the so-called banking secrecy), versus an obligation to disclose such information to foreign tax authorities, create a degree of uncertainty that does not contribute to reversing this trend.

Regulatory architecture: overview of banking regulators and key regulations

The FINMA as the responsible body for regulation of banks in Switzerland

Until January 1, 2009, the responsible body for regulation of banks in Switzerland was the Swiss Federal Banking Commission ("**SFBC**", i.e., the FINMA after January 1, 2009).

On January 1, 2009, the SFBC merged with the Federal Office of Private Insurance ("**FOPI**") and the Anti-Money Laundering Control Authority ("**AMLCA**"), thus concentrating all supervisory powers over the Swiss financial markets within the hands of one single entity, the FINMA. With a view to sustaining the reputation and competitiveness of Switzerland's financial centre, the FINMA's objectives are: (i) protecting creditors, investors and policy holders; and (ii) ensuring the smooth functioning of the financial markets.

The FINMA's scope of regulation encompasses banks, insurance companies, stock exchanges, securities dealers, collective investment schemes, distributors and managers of collective investment schemes, and insurance intermediaries. Among other tasks, the FINMA combats money laundering and oversees the appropriate implementation of self-regulation.

The FINMA acts as an independent entity on functional, institutional and financial levels. The FINMA's supervisory duties are implemented through licensing, regulating, monitoring and enforcement.

As a consequence, any (foreign or domestic) entity intending to exercise a banking activity in Switzerland will have the obligation to request an operating licence from the FINMA. If the FINMA grants the requested licence, it will thereafter monitor the supervised entity to ensure that it complies with all legal requirements provided by Swiss law, and the conditions established in the licence.

The key legislation or regulations applicable to banks in Switzerland

All banks in Switzerland must comply with the following key legislation and regulations: the Swiss Federal Act of November 8, 1934, on Banks and Savings Banks ("**BA**"), the Swiss Federal Ordinance of May 17, 1972, on Banks and Savings Banks ("**BO**"), the Swiss Federal Ordinance of June 1, 2012, on Capital Adequacy and Risk Diversification for Banks and Securities Dealers ("**CAO**"), the Swiss Financial Market Supervisory Authority Ordinance of August 30, 2012, on the Insolvency of Banks and Securities Dealers, as well as the Swiss Financial Market Supervisory Authority Ordinance of November 30, 2012, on Liquidities for Banks. In addition, foreign banks established in Switzerland must comply with the Swiss Financial Market Supervisory Authority Ordinance of October 21, 1996, on Foreign Banks in Switzerland.

Further to the above regulations, banks in Switzerland must comply with additional laws triggered by engagement in specific activities, such as: (i) the Swiss Federal Act of March 24, 1995, on Stock Exchanges and Securities Trading ("**SESTA**") and Ordinance of October 25, 2008, on the Swiss Financial Market Supervisory Authority on Stock Exchanges and Securities Trading ("**SESTO**") when operating on the stock exchange or trading or issuing securities; (ii) the Collective Investment Scheme Act of June 23, 2006 ("**CISA**") and Collective Investment Scheme Ordinance of November 22, 2006 ("**CISO**") when operating with collective investment schemes; and (iii) anti-money laundering regulations in all activities requiring such measures, etc.

In addition, several associations – such as the Swiss Bankers Association and the Swiss Funds Association – contribute to the development of 'soft law' in Switzerland through the promulgation of various guidelines, which play an important role in practice.

The influence of supra-national regulatory regimes or regulatory bodies on Swiss banking regulations

Switzerland's current regulations in financial markets and their evolution are strongly influenced by the international regulatory scene. By way of example, a direct consequence of the global financial crisis of 2008 was the establishment of the so-called Basel III reform of December 2010, which led the Swiss Federal Council to review in its entirety the CAO – the revised version of which is in force since January 1, 2013. Another example is the ratification by Switzerland of the Hague Convention on the Law Applicable to Certain Rights in respect of Securities Held with an Intermediary, and its implementation through enactment of the Swiss Federal Act on Intermediated Securities of October 3, 2008, which also demonstrates the influence of the international scene on Switzerland's domestic legislation.

The Swiss Government is similarly concerned that Swiss financial entities could be excluded from accessing certain markets, and is therefore willing to adapt Swiss legislation to certain foreign standards. This is particularly true in consideration of the European Union.

Finally, Switzerland participates actively in the process of defining the new international standards. To that effect, Switzerland is duly represented on the Basel Committee on Banking Supervision and is, among others, actively involved with the Bank of International Settlements, the Financial Stability Board and the International Association of Deposit Insurers. In addition, Switzerland engages in bilateral agreements with many foreign supervisory authorities. For some specific issues, such as the consolidated supervision of financial groups active on an international level, international cooperation is, by definition, imperative.

Absence of restrictions on the activities of banks in Switzerland

Swiss law allows banks to engage in both commercial and investment banking activities. There are therefore no restrictions equivalent to those of the former US Glass-Steagall Act (or current Volcker Rule).

From a practical point of view, however, when granting a banking licence to a financial institution, the FINMA usually sets certain limits to the bank's activities in the functioning of its business plan.

Changes to the banking regulatory architecture in Switzerland

Recent changes to the Swiss regulatory architecture

Following the financial crisis of 2008, the Swiss regulatory architecture has been modified to address the "Too Big To Fail" issue through the revision of the BA which came into force on March 1, 2012.

The revision of the CAO – which came into force on January 1, 2013 – and several FINMA circulars, reflected the implementation of the Basel III standards.

Proposed changes to the Swiss regulatory architecture

Due to the importance of their repercussions on Swiss banks, the above revisions of the BA and the CAO are introduced in stages until the year 2018. New liquidity regulations will also follow as early as mid-2013.

In addition, the Swiss Parliament is currently analysing the following two legislative projects:

(i) Unclaimed funds: by means of a law or an ordinance, a regulation will establish the process applicable by banks in Switzerland when dealing with unclaimed funds. At the time of this publication, it appears that banks in Switzerland will have ten years to search for the account holder of unclaimed funds. After this initial period, and provided that no-one claims these funds for an additional period of 50 years, banks will be authorised to transfer such amounts to the Swiss State. It is currently unclear whether, following the transfer of funds to the Swiss State, the legislation will grant the owner of these funds another 50 years to claim them.

(ii) Publication of accounts: a recent revision of the provisions pertaining to Swiss corporations and accounting law led to a modification of the rules concerning the establishment of accounts. As a consequence, the Swiss Federal Council and the FINMA will issue implementing provisions applicable to banks.

Recent regulatory themes and key regulatory developments

As a new entity resulting from the merger of three supervisory entities, the SFBC, the FOPI and the AMLCA, the FINMA, as an independent decision-making authority, has just completed its first four-year strategic period. It emerges as an integrated, independent and efficient supervision authority with a clear emphasis on risk-oriented supervision, among them systemic risks and their containment, the enhancement of capital requirements in terms of quality and size, and a rigorous approach to licensing practice.

The new strategic goals adopted in November 2012 show an increased emphasis on prudential requirements for financial institutions, aimed at a consolidation of financial stability and crisis resistance, a risk-based approach and the promotion of integrity, transparency and client protection in business conduct.

Reinforcing clients' protection in the financial market – Draft Swiss Federal Financial Services Act

The Madoff fraudulent scheme and the fate of Lehman Brothers structured products have triggered a series of regulatory or prudential reviews, and proposals on the distribution of such products. The FINMA has published a position paper in 2012, pointing out in particular an inadequate protection of financial market clients, and advocating the introduction of uniform rules of business conduct and product information rules for financial services providers, together with increased supervisory powers to enforce such rules in practice. The proposal further suggests an improvement of civil law regarding claims for damages from retail clients. Of no minor importance is the proposal to introduce the obligation for asset managers to obtain a licence for this activity.

These objectives have now been formalised in a consultation paper issued by the Department of Finance, aiming at a draft federal law by the end of 2013. Aside from cross-sector rules of conduct (and organisation) for all financial service providers and documentation requirements for financial products, the form of prudential supervision to be instituted is still open for discussion (FINMA or self-regulating organisations). Another open issue is whether foreign financial service providers engaged in cross-border activity in Switzerland, and registered as such, should be subject to Swiss rules of conduct or to the foreign equivalent.

New market conduct rules

Following a revision of SESTA and SESTO, which entered into force on May 1, 2013, the amended provisions establish new standards in both supervisory and criminal law with respect to market offences and market abuse. A broader definition of market abuse now prohibits all natural persons and legal entities active on the financial market from engaging in insider trading and market manipulation, whereas, previously, market conduct rules could only be enforced against supervised market participants. FINMA has issued for consultation a fully revised draft Circular containing the implementing provisions of this change in regulation, which are now much closer to international standards.

FATCA

The implementation of FATCA (the US "**Foreign Account Tax Compliance Act**") in Switzerland will generate a considerable administrative burden for the banks in order to be FATCA-compliant and prevent legal and reputational risks. Switzerland has signed with the United States a so-called second model intergovernmental agreement which provides that, *in lieu* of an automatic exchange of information between the US tax authority (the Internal Revenue Service or the "**IRS**") and its Swiss counterpart, Swiss financial institutions shall register with and report directly to the IRS the information required by FATCA. This agreement is still to be ratified by the Swiss Parliament (presumably during summer 2013) and may still be challenged by a facultative referendum.

Bank governance and internal controls

Introduction

Article 3 BA, as well as Articles 8 and 9 BO, set forth the basic requirements in terms of governance and internal controls a Swiss bank must comply with in order to obtain the FINMA authorisation necessary to conduct its business in or from Switzerland. Banks which are acting as securities dealers must obtain a specific licence for this purpose and comply with the (similar) requirements set forth by SESTA and SESTO.

In addition, the FINMA has released several recommendations and guidelines, the most relevant being the FINMA Circular no 08/24 on supervision and internal control within the banking sector dealing with governance and internal control requirements for banks and securities dealers.

Additional or particular requirements apply to financial groups or conglomerates, banks systemically important in Switzerland (i.e., UBS AG and Credit Suisse Group AG) and foreign banks.

Key requirements for governance of banks in Switzerland

Administration and management of the bank

(a) Legal requirements – BA and BO

The BA provides that persons in charge of the administration or management of a bank (i.e., top executive bodies of a bank) must "*enjoy a good reputation and thereby assure the proper conduct of the business operations*" (Article 3 Para. 2 Lit. c BA), and that holders of qualified participations (10% or more of the issued share capital or voting rights of a bank) must guarantee that "*their influence will not have a negative impact on a prudent and sound business activity*" (Article 3 Para. 2 Lit. c^{bis} BA).

Assurance of proper business conduct pursuant to the BA covers matters of personal character and professional qualifications required for the proper management of a bank. With respect to the organisation of a bank, the BO requires that no member of the "*body responsible for direction, supervision and control shall belong to the bank's management*" (Article 8 Para. 2 BO).

(b) Regulatory requirements – FINMA Circular 08/24

According to the FINMA Circular 08/24, the board of directors of a Swiss bank "*must meet the necessary conditions, especially technical expertise, experience and continual availability. It assesses at a minimum annually its own achievement of objectives and work procedures and documents this in writing*". The members of the board of directors shall structure "*their personal and business relations*" to avoid any possible conflict of interest.

Further, at least one third (1/3) of the members of the board of directors must be independent, as defined in the Circular 08/24.

Remuneration

(a) (New) legal requirements – "Minder Initiative"

On March 3, 2013, Switzerland's citizens accepted a proposed amendment to the Swiss constitution dealing with corporate governance and executive compensation (the so-called "Minder Initiative"), which is applicable to Swiss corporations, including banks, listed on a Swiss or non-Swiss stock exchange. The Minder Initiative (which currently is not yet enacted into law) provides, among other things, more rights to the shareholders as to the compensation of the board of directors and the senior executive management.

(b) Regulatory requirements – FINMA Circular 10/1

On October 21, 2009, the FINMA issued the Circular 2010/1 setting the minimum standards for remuneration schemes of financial institutions.

In summary, the FINMA Circular 10/1 sets 10 principles for remuneration schemes, such as, among others, the principle that: (i) the board of directors is responsible for designing and implementing the remuneration scheme and for issuance of the related rules; (ii) remuneration, including variable remuneration, is oriented towards and funded through the long-term economic performance of the bank; and (iii) control functions are remunerated in order to avoid conflicts of interest.

<u>Key requirements governing the organisation of banks' internal control environment</u>

Legal requirements – BA and BO

The BA provides that, if and when required by the scope or importance of business activities, a bank must set up separate bodies for management on the one side, and for direction, supervision and control on the other side. The bank shall further segregate such bodies in order to ensure the effective supervision of the bank's management. The BO provides that the bank shall "*provide for an effective internal segregation of functions between trading, asset management and back office*". Banks may have to comply with further provisions such as, among others, provisions of the recently revised CAO for the purpose of risk diversification.

Regulatory requirements – FINMA Circular 08/24

FINMA Circular 08/24 also defines certain requirements for the organisation of the internal control.

(a) Audit committee

The board of directors must set up an audit committee, if and when the bank is listed on a stock exchange or exceeds one of the following thresholds: (i) total balance sheet over CHF 5bn; (ii) custody account volume over CHF 10bn; or (iii) required capital adequacy according to the CAO over CHF 200m.

The duties of the audit committee involve the monitoring and assessment of the: (i) accuracy of the financial statements; (ii) internal control function within the financial reporting area; (iii) effectiveness of the audit company and its cooperation with the internal audit function; and (iv) the assessment of internal controls, as well as the internal audit covering areas outside the financial reporting area.

(b) Internal audit function
Each bank shall establish an internal audit function in charge of the internal audit and supervision of the bank. The duties and responsibilities of the internal audit function are mainly: (i) risk assessment; (ii) audit planning; and (iii) reporting. The internal audit function is subordinated, reports directly to the board of directors or the audit committee, and has unrestricted access to all books, documents, minutes, records and data storage devices and systems. The head of internal audit is appointed by the board of directors.

(c) Management
The management shall implement the procedures set up by the board of directors regarding the establishing, maintaining and regular testing of internal control functions.
The management is responsible for the implementation of adequate internal systems and processes to guarantee the compliance of the bank with legal, regulatory and internal provisions, as well as with professional conduct rules and customary standards.

(i) Compliance

Each bank shall establish a compliance function. The duties and responsibilities of the compliance function are mainly: (i) support to and consulting of the management and employees in the implementation and monitoring of compliance issues; (ii) assessment of the compliance risks and establishment of a risk-oriented activity plan; (iii) training and informing employees on compliance matters; (iv) reporting to the management and the internal audit of compliance risks and violations; and (v) annual reporting to the board of directors of the compliance risks and activities of the compliance function.

A member of the management is responsible for the compliance function to ensure unrestricted access of compliance to the management. The compliance function has unrestricted access to information, locations and documents within the scope of its function. The compliance function shall form a unit independent from profit-generating business activities.

(ii) Risk control

The duty of the management is also to establish, maintain and supervise a mandatory risk control function, which is, within the bank's overall organisation, independent from profit-generating business activities.

A member of the management is responsible for the risk control to ensure unrestricted access of the risk control function to the management. Depending on the different risk categories of a bank (e.g. market, credit, operational risks, legal and compliance risks, strategic and reputational risks), the risk control function may be composed of different independent departments, each of which must report to the member of the management responsible for risk control.

(d) Risk management
The management of the bank shall ensure risk management at each appropriate organisational level, with methods adequate to and reflecting the particularities of the bank.

Bank capital requirements

<u>Summary of the regulatory capital regime applying to banks in Switzerland</u>

Minimum amount of nominal share capital

Article 3 Para 2 Lit. b BA provides that, in order to obtain its licence, a bank must provide evidence that it has the minimum amount of fully paid-in share capital determined by the Swiss Federal Council.

On that basis, the BO adopted by the Swiss Federal Council provides that the minimum share capital of a bank amounts to CHF 10m. However, in practice, the FINMA requires a new bank to have a minimum share capital of CHF 20m. Such share capital may be subscribed in cash or by contribution in kind, in which case the value of the assets contributed must be verified by an audit firm approved by the FINMA.

Capital adequacy

Article 4 BA sets forth the general principle that banks must maintain individually and on a consolidated basis, appropriate capital adequacy and liquidity. The BA delegates to the Swiss Federal Council the authority to determine the elements of the capital adequacy and liquidity. Further, it establishes the minimum requirement in accordance with business practice and the risks of the bank. The BA provides that the FINMA has the authority to issue implementing provisions in that regard.

With respect to capital adequacy, on the basis of the BA, the Swiss Federal Council has adopted the CAO. The purpose of the CAO is to protect the interests of creditors and the stability of the financial system by ensuring that banks: (i) have capital adequate to support their business operations; and (ii) limit the risk to which they are exposed. More specifically, the CAO provides as a principle that banks must dispose of sufficient capital in order to cover the following risks: (i) credit risks; (ii) market risks; (iii) non-counterparty-related risks; and (iv) operational risks.

The object of the CAO is to regulate:

(a) the eligible capital;
(b) the risks which must be covered by the capital, and the required level of capital necessary to cover such risks (i.e., capital adequacy requirement);
(c) the risk diversification, in particular the limits for large exposures and the treatment of intra-group positions; and
(d) specific requirements applicable only to so-called "systemically" important banks.

<u>Revision of regulatory capital requirements in Switzerland – New Basel III Rules</u>

Like most of the member states of the Basel Committee, Switzerland has until now implemented the international requirements regarding capital by adopting in its own banking law the general principles adopted by the Basel Committee in its Basel I (1988) and Basel II (2004/2006) recommendations.

Under Basel II, the capital requirements of banks were based on three pillars: (i) the minimum requirement of capital for credit, operational and market risks (pillar 1); (ii) a monitoring process whereby the regulators may increase the regulatory capital requirement if weakness is found in a bank (pillar 2); and (iii) market discipline requiring banks to publish details of their risk management activities, risk rating process, etc. (pillar 3).

Following the financial crisis of 2008, a general consensus emerged, both in Switzerland and on an international level, that the banking sector required stricter capital adequacy rules. The new Basel III regulatory framework which was drawn up following such consensus requires banks to hold: (i) significantly more capital; and (ii) capital of a better quality.

In Switzerland, the Swiss Federal Council appointed a Commission of experts in November 2009 to review how to limit the risk that large companies (including large banks) create for the Swiss economy. The Commission was charged: (i) to define the notion "Too Big To Fail"; (ii) to review the consequences of the bankruptcy and liquidation of large Swiss companies in all sectors of the Swiss economy; and (iii) to formulate propositions to limit such risk for the Swiss economy. In the banking sector, under the criteria set out in the report of the Commission, UBS AG and Credit Suisse Group AG were the two banks meeting the definition of large companies creating a systemic risk for the Swiss economy.

Two types of measures were proposed by the Commission of experts to limit the risks, namely: (i) preventive measures (to avoid the bankruptcy); and (ii) curative measures (to enable or to force refinancing of the bank or, as the case may be, a partial orderly liquidation of the bank). Further, the Commission defined four areas of intervention: (i) capital adequacy; (ii) liquidity; (iii) risk allocation; and (iv) organisation.

With respect to capital adequacy, the experts proposed the following three new pillars: (a) a minimum capital requirement necessary to continue the day-to-day operations of the bank (in line with Basel III, of 8% of capital, of which 4.5% of common equity and 6.5% of Tier 1 capital); (b) a capital conservation buffer (of 5.5% of capital, composed of 2.5% of capital and 3% of borrowing), with mandatory conversion in capital (Basel III only requires 2.5% of capital); and (c) a progressive component (which purpose is to manage a crisis, composed of 6% of equity in the form of contingent convertible bonds with progressive triggering events).

Thus, Switzerland largely adopted the Basel III new standards and complemented them with a new capital buffer which is specific to the situation of Switzerland.

The FINMA issued a comprehensive report on October 21, 2011, explaining in detail the new regime, replacing the Basel II standards, including new special rules applicable only in Switzerland (the so-called "Swiss finish").

In summary, in line with the above propositions of the Commission, the new Swiss capital requirement regulations include the following new composition of the required capital (Article 41 CAO):

(a) **a minimum capital requirement** (determined in line with the international regulatory framework);
(b) **a capital buffer**;
(c) **a counter-cyclical buffer** (or so-called Basel Pure); and
(d) **an additional capital** (i.e., additional Swiss requirements applicable depending on the size of the bank).

The new CAO, setting forth in detail the above requirements, entered into force on January 1, 2013. Such Ordinance introduced new instruments under Swiss corporate law such as the contingent convertible bonds ("**CoCo**" or "**bail-in**"). The CoCos qualify as credit notes which, in case a pre-defined triggering event occurs, automatically convert into capital. Such conversion increases the share capital of the bank and correspondingly reduces the amount of liability of the bank, and improves its liquidity. Further, banks may also now issue credit notes, whose terms provide automatic write-off in case of the occurrence of certain events.

Capital adequacy

The CAO defines the eligible capital as the Tier 1 Capital (T1) plus the Tier 2 Capital (T2). Tier 1 Capital consists of Common Equity Tier 1 Capital (CET1) and Additional Tier 1 Capital (AT1). The CAO defines what is eligible as: (i) Common Equity Tier 1 Capital (CET1); (ii) Additional Tier 1 Capital (AT1); and (iii) Tier 2 Capital (T2) (see Articles 18, 21, 27 and 30 CAO).

Minimum capital requirement

After the deductions and corrections to be made to the capital in accordance with Articles 31 to 40 CAO, banks must hold total capital in the amount of 8% of the risk-weighted positions as minimum required capital (Total Capital Ratio). A minimum of 4.5% of the risk□weighted positions must be covered by Common Equity Tier 1 Capital (CET1), and a minimum of 6% must be covered by Tier 1 Capital (T1 Capital Ratio) (Article 42 CAO).

Capital buffer

This new requirement shall enter into force on January 1, 2016. At that time, banks shall have, at all times, to hold a capital buffer of 2.5% of their risk-weighted positions in the form of Common Equity Tier 1 Capital. However, a bank whose capital buffer temporarily falls below the above requirements due to exceptional and unpredictable circumstances, such as a Swiss-wide or international financial crisis, shall not be deemed to be in breach of the capital requirements. Finally, if a bank is below the capital buffer of 2.5%, the FINMA must set an individual grace period to the bank in order to restore its capital buffer of 2.5% (Article 43 CAO).

Countercyclical buffer

Upon the Swiss National Bank's request, 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 Common Equity Tier 1 Capital, in order to: (a) increase the banking sector's resilience against the risk of excessive credit growth; or (b) counteract the risk related to excessive credit growth (Article 44 CAO).

Additional capital

Banks must hold additional capital in accordance with the instructions of the FINMA. The FINMA may exclude certain categories of banks from such obligation (Article 45 CAO). This additional capital should specifically cover the risks that are not covered or not sufficiently covered by the minimum required capital if a risk-oriented approach is applied to the banks.

Together with the capital buffer, the additional capital is meant to ensure compliance with minimum capital requirements even in unfavourable conditions.

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

<u>Regulations applying to banks' dealings with third parties</u>

Regulations applicable to relationships with customers

The BA and the BO do not contain rules directly applicable to the relationship between a bank and its customers, whether retail or institutional.

(a) SESTA

When the bank is acting as securities dealer, it has to comply with Article 11 SESTA which sets the minimum requirements a securities dealer shall observe towards its clients. Taking into account the client's business expertise and professional knowledge, the bank has a duty of: (i) disclosure, in relation to the risks associated with certain transactions; (ii) diligence; and (iii) loyalty, avoiding conflict of interest.

(b) CISA and CISO

When the bank is offering or making available to its clients shares or units in collective investment schemes, it has to comply, among others, with CISA and CISO requirements, mainly Chapter 4 "Code of conduct" of the CISA (Articles 20 *et seq.*), which provide that the bank has a duty of (i) information, (ii) diligence, and (iii) loyalty.

(c) SCO

The relationships between a bank and its customer are ruled by the general provisions of the Swiss Code of Obligations of March 30, 1911 ("SCO"). In this respect, the Swiss Federal Supreme Court ruled that banks are exercising an activity subject to licence by an authority and may therefore only contractually exclude their liability for associates for minor negligence (and not for gross negligence). Asset management and investment advice activities are mainly regulated by the provisions of Articles 394 *et seq.* SCO regarding the agency contract.

In connection with such provisions of the SCO, the Swiss Federal Supreme Court recently broadened the application of Article 400 Para. 1 SCO to banks acting as agents for their clients, and set out their obligations at all times to account (upon request of their clients) the management of their business and restitute all the assets to their clients directly related to the execution of the clients' orders. This includes retrocessions acquired by banks acting as asset managers for their clients. Following such decision and as a new step, the FINMA issued a newsletter entitled Supervisory Measures – Retrocession / Banks on November 26, 2012, under which the FINMA indicated that, notwithstanding the fact that, as regulator, the FINMA was not responsible for the compliance and enforcement of clients' claims under civil law, it would expect banks to adopt certain organisational measures related to the new decision of the Swiss Federal Supreme Court, including to contact and inform their clients affected by such decision on retrocessions.

When the bank only acts towards the client as depository institution (execution only), Articles 472 *et seq.* SCO regarding bailment contract are applicable.

(d) Contractual provisions and unfair competition

It is customary that the contractual relationships between a bank and its client are subject to the bank's general terms and conditions, which are mainly to be construed in accordance with the general provisions of the SCO. However, Article 8 of the Swiss Federal Act Against Unfair Competition in its revised version of July 1, 2012, prohibits the use of terms and conditions that, to the detriment of consumers and contrary to the requirement of good faith, provide for a significant and unjustified disproportion between contractual rights and contractual obligations.

(e) Self-Regulatory Organisation (SRO) regulations

In its Circular 08/10, the FINMA has recognised certain self-regulations as the minimum standard requirements applicable to certain financial institutions, of which the following are relevant for banks in their relations with clients:

(i) *Self-regulation of the Swiss Bankers Association*

Guidelines on the Treatment of Dormant Account.

Guidelines on Informing Investors about Structured Products.

Code of Conduct for Securities Dealers Governing Securities Transactions.

Portfolio Management Guidelines.

(ii) *Self-regulation of the Swiss Fund Association*

Guidelines on Transparency with regard to Management Fees.

Guidelines on the Distribution of Collective Investment Schemes.

Code of Conduct for the Swiss Fund Industry.

Code of Conduct for Asset Managers of Collective Investment Schemes.

Guidelines on "key investor information".

Regulations applicable to relationships between banks and third parties

There are no particular provisions or regulations governing the relationships between banks and third parties, other than those usually applying to business relationships, such as, among others, the SCO (see also above sections (c) and (d) under 'Bank capital requirements, Capital adequacy').

Regulatory mechanisms for addressing customer complaints against banks

The Swiss Bankers Association set up in 1993, as an alternative dispute-resolution procedure, the services of an ombudsman. The services of the Swiss Banking Ombudsman are free of charge for the clients of banks and comprise mediation and assistance to persons: (i) raising claims against banks which are members of the Swiss Bankers Association; or (ii) searching for dormant assets.

The FINMA does not intervene in disputes between a bank and its client, although it may take certain measures that would benefit the client, but only exceptionally and in case of serious violation of supervisory provisions (Article 35 Para. 1 of the Federal Act on the Swiss Financial Market Supervisory Authority of June 22, 2007). The recent FINMA newsletter mentioned above and entitled Supervisory Measures – Retrocession / Banks on November 26, 2012, is one example of such measures.

Compensation schemes covering customers of banks in the case of the failure of those banks

The BA provides that, in case of bankruptcy of a bank, investors will be allocated an amount not exceeding CHF 100,000 on their assets deposited with such bank (privileged deposits, Article 37a BA). Banks shall always maintain assets in Switzerland or domestically backed claims corresponding to an amount of 125% of their privileged deposits. Such privileged deposits are immediately repaid out of liquid assets and outside the bankruptcy procedure (Article 37b BA). Article 37h Para. 1*bis* BA provides that banks shall ensure that their privileged deposits with Swiss branches are secured. The Swiss Bankers Association formed in 2005 the "*Swiss Banks' and Securities Dealers' Depositor Protection Association*", the purpose of which is to implement the measures laid down in the BA.

Conclusion

In summary, Switzerland has undertaken, in the last few years, an in-depth reform of its banking system and monitoring instruments in the banking sector. This willingness to improve the existing legal and regulatory structures has been mainly driven by the recent financial crises, a general paradigm change in this branch of industry – especially in relation to the exchange of information in tax matters – a growing international pressure on Switzerland and its banking institutions, as well as a willingness of Swiss political institutions and professional associations to maintain the competitiveness of the Swiss financial sector, despite increasing constraints. One may reasonably expect that the various reforms undertaken so far are only the first of a long series of renewed and increasingly strict standards of supervision and regulation in the banking Swiss sector.

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