PRAGER DREIFUSS

RECHTSANWÄLTE
ATTORNEYS AT LAW

MÜHLEBACHSTRASSE 6, 8008 ZÜRICH
TEL +41 1 254 55 55 FAX +41 1 254 55 99
daniel.hayek@prager-dreifuss.com

Zurich – Bern – Brussels

www.prager-dreifuss.com

By Prager Dreifuss – Attorneys at Law

GENERAL FRAMEWORK AND CONDUCT OF BUSINESS

Switzerland is one of the world's leading financial centres and the banking industry is one of the most important industries of the national economy. In 2002 the total assets and liabilities of banks in Switzerland reached SFr2.25 trillion ($1.7 trillion), the value of securities portfolios held in custody accounts by domestic bank offices amounted to SFr2.94 trillion, and about 3% of working people were engaged in the banking industry.

The International Monetary Fund carried out a Financial Sector Assessment Programme in Switzerland in 2001. The IMF gives Switzerland's financial and supervisory system excellent marks (www.efd.admin.ch). The IMF does make recommendations for improvement, but largely in areas that have already been identified as in need of revision by national task forces and authorities. In particular, a commission of experts appointed by the Federal Council in 2001 and headed by professor Ulrich Zimmerli is mandated to lay the foundations of a fully integrated financial market regulatory body that will be administratively and financially independent.

Sources of banking law

The legal sources governing the authorization and regulation of banking activities in Switzerland are many. The main provisions are contained in the federal Banking Statute, which has been revised several times since its first enactment in 1934. The Banking Statute is complemented by the Federal Banking Ordinance and the Federal Ordinance on Foreign Banks.

The supervisory authority over banks, investment funds, securities dealers and stock exchanges is the Federal Banking Commission (FBC; www.ebk.admin.ch). The FBC has been given different powers by supervisory legislation including the legislative power to enact ordinances, the most prominent example being the Ordinance on Foreign Banks. The FBC also has the power to issue circulars, by which it provides information on the application of legal regulations, makes recommendations, or seeks certain types of information. Although these circulars do not impose direct obligations, if they are ignored the FBC will most probably issue a decree along the same lines.

Last but not least, self-regulation has always played an important role in Switzerland's banking and finance industry. In particular, the Swiss Bankers Association has issued a number of recommendations, guidelines and conventions. These form part of the statutory supervisory standard insofar as compliance with them has to be verified by the official auditors (FBC-Circular 96/3). Furthermore, the Swiss Supreme Court held that generally accepted rules of conduct or practices for a given profession or a certain trade can be referred to when defining due diligence (Federal Supreme Court Decision 115 II 64; www.bger.ch).

About the authors

DANIEL HAYEK

Daniel Hayek, born 1964, graduated from the University of Zurich in 1990 (lic iur) and from New York University School of Law in 1995 (LLM in corporate law). He was admitted to the bar in 1993. Before he joined Prager Dreifuss in 1997 as an associate he worked for another well known business law firm. Since 2001 he has been a partner with Prager Dreifuss in Zurich.

Daniel Hayek's areas of specialization are international banking and finance law with a focus on structured finance, capital market law, securities law company law, mergers and acquisitions and litigation (including arbitration) relating thereto. His professional languages are German, English and French. Daniel Hayek regularly contributes to publication in his areas of practice and is a member of various professional organizations, including the Zurich, the Swiss and the International Bar Associations.

About the authors

DR GION JEGHER

Dr Gion Jegher, born in 1967, graduated from University of Basel in 1993 (lic iur) and from Duke University in 1996 (LLM). He was admitted to the bar in 2000. In 2002 he earned a doctorate at the University of Basel and won the prestigious Professor Walther Hug Price with his thesis. After having worked for three years as a research and teaching assistant at the University of Basel, he worked for several years as an independent contract lawyer. In 2002, he joined Prager Dreifuss as an associate. His main practice areas are private international law, finance law, company law, contract law, and litigation and arbitration. Gion Jegher has published several treatises and law review articles in the field of his expertise. He is a member of the Zurich and the Swiss Bar Association. His professional languages are German and English. He also has good knowledge of French and some knowledge of Russian.

Definition of a bank

Banks are required to obtain a licence from the FBC before engaging in business activities (article 3 paragraph 1 of the Banking Statute). The term *banks* is roughly defined in the Banking Statute as encompassing ordinary banks, private banks and saving banks (article 1). Private banks are banks in the legal form of sole proprietorship, general and limited partnership, and enjoy a number of privileges if they do not publicly solicit deposits (article 3 paragraph 2 of the Banking Ordinance; article 5 paragraph 2, article 6 paragraph 6 of the Banking Statute). The Swiss National Bank, the traditional role of which is that of a central bank, is governed by the Banking Statute only to the extent expressly stated therein (article 1 paragraph 5 of the Banking Statute). With respect to the cantonal banks (Switzerland is a federal republic with 26 cantons and a federal government), the Banking Statute contained a number of privileges, many of them but were abolished as of October 1999 (article 3a of the Banking Statute).

The Banking Ordinance further defines the term *banks* as enterprises that are mainly active in the field of finance and that in particular (i) accept deposits from the public on a professional basis or solicit these publicly in order to finance in any way for their own account an undefined number of persons or enterprises, or (ii) who refinance themselves in substantial amounts from a number of *banks* that are not significant shareholders in order to provide any form of financing for their own account to an undefined number of persons or institutions (article 2a of the Banking Ordinance).

SUPERVISORY REQUIREMENTS

Licence requirements, organization of a bank and corporate governance

As already mentioned, banks are required to obtain a licence from the FBC before engaging in business activities (article 3 paragraph 1 of the Banking Statute). Banks may not be registered in the Commercial Register before such a licence has been granted (article 3 paragraph 1 of the Banking Statute). only banks that have obtained a banking licence are allowed to use the term *bank* or *banker* in their corporate name or advertising activities (article 1 paragraph 4 of the Banking Statute). There are several licence requirements, which have to be complied with also after the licence has been granted (article 3 paragraph 2 and article 23^{quinquies} of the Banking Statute):

The bank has to provide a precise definition of the scope of business in its articles of association, by-laws, and internal regulations and provide a management organization adequate for its business activities (article 3 paragraph 2 lit a of the Banking Statute). Where the purpose or the scope of the business requires, the bank has to create separate bodies for the management on the one hand and for the direction, supervision and control on the other hand, and the bank has to separate the powers of these bodies in a manner so as to ensure the effective supervision of the management of the bank (article 3 paragraph 2 lit a of the Banking Statute). In particular, no person is allowed to belong to both of these two bodies, except for special cases for which the FBC may grant an exemption (article 8 of the Banking Ordinance). Apart from this dualistic structure imposed on Swiss banks by the Banking Statute, there are presently three sets of rules ensuring good corporate governance of banks in Switzerland: (i) the general Swiss company and stock exchange laws, which contain sophisticated rules regarding corporate governance; (ii) rules of self-regulation of the Swiss Exchange (SWX), in particular its Corporate Governance Directive, which came into force on one July 2002 (www.swx.com/admission/admission-_en.html); and (iii) the Code of Best Practice, a body of soft-law released by a highly respected group of specialists in March 2002 (www.economiesuisse.ch).

The Bank has to have a fully paid-up minimum equity capital of SFr10 million (article 3 paragraph 2 lit b of the Banking Statute; article 4 paragraph 1 of the Banking Ordinance). In particular cases, the FBC may grant an exemption (article 4 paragraph 3 of the Banking Ordinance).

The persons entrusted with the administration and management of the bank have to enjoy a good reputation and ensure the proper conduct of business operations (article 3 paragraph 2 lit c[bis] of the Banking Statute). This test has been extended to those who hold qualified participations, the influence of which may not be detrimental to prudent and proper business operations (article 3 paragraph 2 lit c of the Banking Statute). To ensure the operation of this provision, each natural or legal person has to notify the FBC before directly or indirectly acquiring or disposing of a qualified participation in a bank organized under Swiss law (article 3 paragraph 5 of the Banking Statute).

The persons entrusted with the management of the bank have to be domiciled in a place where they are able to effectively and responsibly manage the bank (article 3 paragraph 2 lit d of the Banking Statute). To bring Swiss law in line with the law of the EU, the former requirement that senior managers are Swiss and have their domicile in Switzerland was abandoned in 1994.

The bank has to file its articles of association, by-laws and internal regulations with the FBC and to notify the FBC of any subsequent amendments to these in so far as they concern its business purpose, scope of operations, registered capital or internal operation (article 3 paragraph 3 of the Banking Statute).

Banks organized under Swiss law have to notify the FBC before setting up a subsidiary, branch, agency or representation abroad (article 3 paragraph 7 of the Banking Statute).

Banks under foreign control

Banks under foreign control represent a special category and are subject to special licence requirements. The Banking Statute states that the licence to set up a bank that is to be organized under Swiss law, but in whose case a controlling foreign influence exists, as well as the licence to set up an office, a branch or an agency of a foreign or foreign-controlled bank and the licence to appoint a permanent representative of a foreign bank shall be made subject to the following additional requirements: (i) the country of residence of the foreign person with qualified participation shall guarantee reciprocity, provided no contrary international obligations exist; (ii) the corporate name of the bank shall not indicate or suggest that the bank is under Swiss control (article 3[bis] paragraph 1 of the Banking Statute). The reservation of reciprocity violates the most-favoured-nation-principle embodied in article II of the General Agreement on Trade in Services (GATS), which came into force in Switzerland on September 1 1996. Since that time, therefore, the reciprocity requirement applies only with respect to non-member states. The setting up of branch offices, agencies and representations of foreign banks is regulated in more detail by the Ordinance on Foreign Banks.

The Banking Statute defines a bank to be under a controlling foreign influence, if a foreigner with a qualified participation directly or indirectly holds more than 50% of the voting rights in the bank or a significant influence on it is exercised in another manner. A foreigner is deemed to be (i) a natural person who is neither a Swiss citizen nor has obtained a licence for permanent residency in Switzerland or (ii) a legal entity or a partnership which has its registered office abroad or, if it has its registered office in Switzerland, is controlled by a foreigner as defined under (i) (article 3[bis] paragraph 3 of the Banking Statute).

The special licence requirements of article 3[bis] of the Banking Statute also apply if a controlling foreign influence exists only after the bank or its office, branch or agency has been set up (article 3[ter] paragraph 1 of the Banking Statute). In such a case, an additional licence has to be obtained. Such an additional licence is also required, if a bank under foreign control experiences a change in a foreigner holding a qualified participation. To ensure that these provisions are complied with, the members of the board of directors and the management of the bank have to inform the FBC of all matters that may lead one to conclude that the bank is under foreign control or that there has been a change

in a foreigner holding a qualified participation (article 3ter paragraph 3 of the Banking Statute).

Equity and liquidity requirements

To ensure permanent solvency, banks have to maintain an appropriate ratio between their equity and their liabilities (article 4 paragraph 1 lit a of the Banking Statute). This suggests a liability-oriented approach to equity in relation to borrowings. However, the detailed provisions of the Banking Ordinance (article 11–14a) look at the entire balance sheet. Assets, in particular credits, as well as certain off-balance-sheet entries, in particular derivatives, have to be underlaid with equity. In accordance with the Basel Capital Accord 1988, the required equity is calculated by the indirect method, that is, the asset positions are risk weighted and then underlaid with a standard percentage rate of 8% (article 12 the Banking Ordinance).

To ensure permanent solvency, banks have also to maintain an appropriate ratio between their liquid and marketable assets on the one hand and their short-term liabilities on the other (article 4 paragraph 1 lit b of the Banking Statute). According to the detailed provisions of the Banking Ordinance (article 14–20), liquid assets and easily realizable assets have always to amount together to a minimum of 33% of the short-term liabilities (article 18 paragraph 1 of the Banking Ordinance). In addition, the liquid assets have to amount to a minimum of a specific percentage of certain liabilities (article 19 of the Banking Ordinance). Banks have to report on cash liquidity on a monthly basis and on total liquidity on a quarterly basis (article 20 the Banking Ordinance). Banks must also ensure adequate liquidity within their corporate group (article 18 paragraph 3 of the Banking Ordinance).

Market risks and netting

Market risks are changes in interests rates, share prices, exchange rates and commodity prices. Based on the Basel Committee's *Amendment of the Capital Accord to Incorporate Market Risks* the provisions of the Banking Ordinance regarding capital adequacy for market risks were revised in 1997. To provide a capital cushion against any losses that the banks (or securities traders) could suffer due to market fluctuations, market risks from interest rates instruments and from equity in the trading book as well as market risks in foreign exchange, gold and commodities have to be recorded for the entire institution and underlaid by capital resources (article 11 et seq of the Banking Ordinance). Based on a delegated power conferred on it by the Banking Ordinance (article 12p), the FBC issued a circular providing detailed guidelines on capital requirements to secure market risks (FBC-Circular 97/1). The Basel Capital Accord is under revision again (Basel II), with implementation in member countries expected by the end of 2006 (www.bis.org/bcbs/index.htm).

After the European Capital Adequacy Directive (93/6), the revision of the Banking Ordinance in 1997 introduced a *de minimis* rule. A bank may calculate capital requirements in accordance with the standards set out in article 12a–12k of the Banking Ordinance, if the thresholds laid down in the guidelines of the FBC are not exceeded (article 12l paragraph 2 of the Banking Ordinance). In principle, the capital requirements have also be determined on a consolidated basis (13a of the Banking Ordinance).

Netting is a means to secure credit risks related to derivative financial instruments by setting-off against each other different types of claims based on existing statutory regulations or individual contractual provisions. Since 1994 netting by novation and close-out netting have been recognized in Switzerland (12f of the Banking Ordinance). Netting agreements entered into by banks have to be examined by the statutory banking auditors with respect to their recognition and enforcement in the relevant jurisdictions. There is a netting group related to the Swiss Institute of Certified Accountants and Tax Consultants that assesses netting agreements submitted to it by the banks. The responsibility, however, rests with the banks and their auditors.

Accounting standards and auditors

The obligations of banks to present their financial statements is set out in the company law and, in a much more detailed way, in the Banking Ordinance (article 6 of the Banking Statute; article 23–28 of the Banking Ordinance). The guidelines of the FBC, revised on December 31 2002, are also important, as they have to be followed in the preparation and structure of the annual and interim financial statements (article 28 paragraph 1 of the Banking Ordinance).

Unlike most other countries, Switzerland has a dual system of supervision. Direct and continuing supervision is the duty of the banks' auditors, whereas the supervisory authority, the FBC, is only responsible for the top supervision. Due to this dual system the auditors have a double mandate, which makes them vulnerable to conflicts of interests. Having recognized that the existing rules do not take enough account of

the changes in the accounting profession, the FBC initiated a revision of the law regarding auditing in the banking industry, which is still underway. In the meantime, the Swiss Bankers Association passed guidelines for securing the independence of financial analysis, which entered into force on July 1 2003. Because the FBC has approved these guidelines as binding conduct rules and implemented them into a circular, compliance with these rules will be examined.

Sanctions

The FBC issues decrees necessary to enforce and supervise compliance with the provisions of the Banking Statute (article 23bis paragraph 1 of the Banking Statute). The FBC may demand from the banks and its auditors any information or document necessary to fulfill its duties (article 23bis paragraph 2 of the Banking Statute). If the FBC learns of a violation of the Banking Statute or other irregularities, it has to issue the decrees necessary to restore proper conditions (article 23ter paragraph 1 of the Banking Statute). In case an enforceable decree is not complied with the FBC can undertake the required action itself (article 23bis paragraph 2 of the Banking Statute). The FBC has the authorization to suspend voting rights linked to shares that are held by shareholders or companies with a qualified participation (article 23ter paragraph 1bis of the Banking Statute). The ultimate sanction available to the FBC is the withdrawal of the licence in case the licence conditions are no longer fulfilled or if the bank grossly violates the legally imposed duties (article 23^{quinquies} paragraph 1 of the Banking Statute). It is the general view that the list of sanctions available to the FBC needs to be extended by several financial and professional measures, and a respective revision of the law is underway.

Investor protection

The Banking Statute contains special provisions with respect to banks facing difficulties making payments. Section 11 regulates the postponement of maturity, section 12 sets out rules on moratoria, and section 13 provides special rules concerning bankruptcy proceedings and arrangements with creditors. The provisions of the Banking Statute are supplemented by several ordinances. Insofar as these banking specific rules do not provide for a regulation, the Federal Act on Debt Execution and Bankruptcy is applicable.

Two important rules of the Banking Statute must be addressed here. Firstly, article 37a of the Banking Statute providing a depositor's privilege. Claims (i) from accounts to which income from employment, or annuities or pensions from employers are regularly transferred, and (ii) from savings deposits or investment books or accounts shall in the maximum amount of SFr30,000 be allocated to a special bankruptcy category before the class of ordinary creditors (article 37a of the Banking Statute); as these SFr30,000 do not constitute a guaranteed fund, Swiss law is not in line here with the European Deposit Guarantee Directive (94/19). Secondly, article 37b of the Banking Statute provides a right for depositors to a separate settlement: in case of a bank's bankruptcy deposited assets do not form part of the estate but are separated in favour of the depositor. The term *deposited assets* is widely defined in article 16 of the Banking Statute encompassing, inter alia, not only movable goods and securities of the depositor but also movable goods, securities and claims which the bank holds on a fiduciary basis for the depositor.

The law regarding restructuring and bankruptcy of banks as well as depositor protection is scattered, confusing and in need of revision. In November 2002, the Federal Council brought a draft before parliament aimed at reforming this part of the law. The intended revision will simplify and unify the procedure for the restructuring and liquidation of banks and improve depositor protection up to the level of the EU.

In 1993, the Swiss Bankers Association created the office of the Banking Ombudsman by an act of self-regulation (www.bankingombudsman.ch). The Banking Ombudsman, who is subject to a duty of confidentiality, is an independent, neutral and cost-free source of information and investigation regarding banking issues. The Banking Ombudsman has a right to obtain files and position statements from the banks. Although his settlement suggestions are not binding on the parties, the banks often accept the Ombudsman's proposals.