New regulations for the Swiss custody business

30.01.2023

Key takeaways

- **Unlike deposits, securities deposited with a bank are segregated in the event of the bank's bankruptcy. Securities are therefore not included in the bankruptcy estate from the outset. However, in order for this legal claim to be enforced in a specific case, it must be possible to identify the customer holdings as promptly as possible.**
- **Until now, the custody of intermediated securities did not ensure the separation of proprietary and client holdings throughout the entire custody chain.**
- **In the course of the latest adjustments to bank insolvency and deposit insurance as of January 1, 2023, this has now been changed, further strengthening investor protection.**

Improved investor protection in banking legislation

On January 1, 2023, a number of new banking law provisions came into force, which, among other things, provide for a faster payout of privileged deposits in the event of bank bankruptcy. In contrast to deposits, securities deposited with a bank (deposit values), in the event of bankruptcy, are segregated. Securities therefore do not fall into the bankruptcy estate from the outset. For this legal claim to be enforced in a specific case, however, it must be possible to identify the customer portfolios as promptly as possible. Under the previous law, the so-called segregation of securities portfolios was only incompletely implemented. For example, when securities, deposited as intermediated securities, were held in custody, a separation of proprietary and customer holdings was not ensured throughout the entire custody chain. In the course of the adjustments to bank insolvency and deposit protection, as of January 1, 2023, this was changed, thereby further strengthening investor protection.

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New complete segregation in the custody chain

General information on the Swiss custody business

In Switzerland, different types of financial institutions and banks may carry out the safekeeping of assets. Accordingly, the legal provisions applicable to the assets' safekeeping are included in various laws: the Banking Act (BankA), the Financial Market Infrastructure Act (FinMIA), and the Intermediated Securities Act (FISA). Not applicable, however, are the rules of conduct for financial service providers contained in the Financial Services Act (FinSA). The pure custody business does not qualify as a financial service. The FinMIA contains licensing and organizational rules for central securities depositories, as well as for certain specific asset segregation rules that apply to direct participants of central securities depositories; these rules may include banks acting as custodians within the meaning of the FISA. Other financial intermediaries that may act as custodians -within the meaning of the FISA- include securities firms (formerly securities dealers), (pursuant to Art. 41 et seq. of the Financial Institutions Act (FinIA)) and fund management companies (pursuant to Art. 32 et seq. FinIA), both of which are subject to FINMA's prudential supervision. In practice, the custodians are most commonly banks. For increased investor protection, the safekeeping of assets of collective investment schemes, under the Collective Investment Schemes Act (CISA), must always be entrusted to banks.

In addition to the bank's internal custody system, there is a national securities depository, SIS (SIX SIS AG). As of 26 September 2017, SIS itself has been licensed as a central securities depository and is thus subject to the FinMIA and supervised by FINMA (previously, SIS was licensed as a bank under the BankA). Even in the days of physically issued securities, no longer was there a physical separation between securities held by the custodian and securities held for clients. Securities were mixed and stored in sequential order by serial number and separated for accounting purposes, i.e., via books and records.

As of January 1, 2010, fungible securities can be deposited as so-called book-entry securities (intermediated securities) in accordance with FISA's special provisions. Here, the securities are deposited either with SIS or with a custodian, which then credits these securities to the securities accounts of the persons who have deposited them. If the securities in question are either dematerialized or are dematerialized securities and therefore cannot be physically deposited, they are deemed deposited within the SIS upon entry in the main register of the depository and then credited to the individual accounts of the owners.

What is a custody chain?

In its simplest form, a mediatized custody system consists of a "pyramid" (custody chain) of custody contracts with three levels: At the top is a national central securities depository (CSD). There, the issues are either physically deposited in collective securities accounts or (electronically) recorded in registers. The middle level consists of various financial intermediaries (custodian banks and the like) for which the CSD maintains custody accounts. At the base of the pyramid are the individual investors who hold their holdings in a custody account with a custodian.

The holdings of a securities account held at the CSD for a custodian may all be held in the name of the custodian in a collective account (omnibus account). In this case, it is not readily apparent whether the holdings are its own holdings or customer holdings. While this circumstance increases confidentiality, it also makes it more difficult for investors to assert their claims in the event of the custodian's insolvency.

This possible difficulty is precisely the problem addressed by the segregation, which requires not only that the custodian's own holdings be kept separate from the holdings of its customers but also that the holdings of one customer be kept separate from the holdings of other customers. This arrangement need not be ensured by separate securities accounts (see below). A segregation by books and records is also sufficient. Segregation leads to a better overview of the legal relationships and prevents the creditors of a custodian bank from accessing the customer portfolios in the event of bankruptcy. Segregation also serves to accelerate the bankruptcy proceedings. Ultimately, however, the decisive factor is always whether the investor is entitled to segregation in bankruptcy under the applicable national law.

Previous commitment only applied at the top of the custody chain

In contrast to deposits (Art. 37a BankA), custody assets (e.g., shares and fund units) are a customer's property. By law, they are fully segregated and surrendered in bankruptcy proceedings (Art. 37d BankA). This segregation, however, is cumbersome or even difficult if the customers' holdings are not separated from the custodian's own holdings.

Under previous law, the obligation to separate proprietary and customer holdings only applied at the top of the custody pyramid for CSDs and their (direct) participants (Articles 69 and 73 FinMIA). However, no obligation existed for longer custody chains for the custodians following the initial custodian. The legislator decided to close these gaps by extending this obligation to the entire domestic custody chain and to the first link abroad.

The New Regulation in the Intermediated Securities Act

For this purpose, the new Art. 11a FISA requires a custodian to keep its own and third-party holdings separate in its books (para. 1). If the custodian holds its own and third party holdings with a third party sub-custodian in Switzerland, it must hold its own and the third party holdings in different securities accounts. Third-party sub-custodians must offer custodians the option of holding their own and third-party holdings in different securities accounts (para. 2).

A so-called "omnibus customer account segregation" is sufficient everywhere. Only own holdings, on the one hand, and customer holdings, on the other hand, must be booked to separate accounts. It is not required to book the holdings of the individual customers to individual accounts.

A direct consequence of this omnibus client account segregation is that clients' holdings can no longer be used to satisfy rights of set-off or netting and/or security interests of the third-party sub-custodian vis-à-vis the custodian. The new provision is thus suitable to strengthen the protection of investors who, under the previous law, were not protected against the consequences of a shortfall of assets. Furthermore, the segregation improves the clarity of the legal relationships and serves to accelerate the proceedings in the event of a custodian's bankruptcy.

Regarding safekeeping abroad, the Swiss depository must now agree with the first foreign third-party depository that the latter will hold the proprietary and third party holdings in different securities accounts (para. 3). If an agreement, pursuant to para. 3, is not possible under the law of the country concerned or for operational reasons, the Swiss depository shall take other measures that offer the account holder a comparable level of protection (para. 4).

The purpose of this provision is to offer Swiss investors comparable protection in the event of safekeeping abroad, as in the event of third-party safekeeping in Switzerland.

Finally, the Swiss custodian, holding third-party holdings with a third-party custodian, must provide investors, in advance, with information in a standardized manner, in paper form or electronically, on the implementation of these safeguards, the risks involved in holding assets abroad, and the associated costs (para. 6).

Next steps

According to the explanations of the Federal Council, introducing public consultation on the amendments, the new provisions affect Swiss banks to a very different extent. Various banks, especially internationally active ones, had ensured consistent segregation in Switzerland earlier at the first depository abroad.

Indeed, analogous provisions can be found in international recommendations and standards such as those of ISOCO and in EU law (Art. 38 CSDR; Art. 16 para. 8 MiFID II; and Art. 2 para. 1 lit. d of Delegated Directive (EU) 2017/593 implementing MiFID II). Institutional clients (such as investment funds or pension funds) from the EU, but also from the Anglo-Saxon region, therefore already demanded consistent segregation of holdings on a contractual basis in order to appoint Swiss banks as custodians.

The new provisions therefore do not lead to an actual change in circumstances in all cases. However, Swiss custodian banks that have already implemented the new requirements voluntarily or at the request of their customers can also benefit from the fact that Swiss law has been further aligned with international standards. In any case, this will make it easier to prove that investors' interests are protected in the event of insolvency.

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