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FinTech Regulation: Blockchain, Robo Advice, Initial Coin Offerings –

Innovative technologies are hitting the financial market. Despite a FinTech initiative of the Swiss government, the revised banking ordinance and the recently-amended regulation on anti-money laundering, Swiss law and regulation still provide little guidance on the new challenges and opportunities. This Newsletter lays out the new rules and remaining loopholes.

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FinTech Regulation: Amendment to the banking ordinance to be implemented per 1 August 2017.

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The Swiss Federal Department of Finance has partially amended the banking ordinance to allow more flexibility for FinTech companies. The changes are rather limited, however. The amended provisions will enter into force per 1 August 2017.

Currently no laws and regulations on FinTech

As per today, Swiss law and regulation does not provide for a specific set of rules on FinTech and their business activities. FinTech companies may therefore be subject to a variety of norms set out in the data protection act, the consumer lending regulation, anti-money laundering law and even banking regulation. When it comes to the licensing of financial services activities, it is the crux of Swiss regulation that only a very limited number of categories of licences are available. In general terms, Swiss law and regulation distinguishes between the following regulated financial institutions that each require a licence from the Swiss Financial Market Supervisory Authority (FINMA):

1. banks;
2. domestic and foreign securities dealers;
3. insurance companies;
4. fund management companies and asset managers of Swiss or foreign investment funds; and
5. independent asset managers, acting exclusively in their clients' names based on powers of attorney.

Banks are defined as entities that are active mainly in the area of finance and in particular, but in a non-exclusive understanding, those who accept deposits from the public on a professional basis or solicit these publicly to finance in any way, for their own account, an undefined number of unrelated persons or enterprises (ie, more than 20 clients), with which they form no economic unit, or who refinance themselves to a substantial degree from third parties to provide any form of financing for their own account to an undefined number of unrelated persons and institutions.

A FinTech company providing bitcoin wallets to its customers which allow repayment in fiat money (ie, money governed by regulation or law) would very quickly fall under banking regulation and may require a banking license.

In addition, there is no bespoke regulation as to the use of e-money or virtual currencies in Switzerland. The Swiss Federal Council published a report on virtual currencies such as bitcoin in 2014, but it refrained from proposing specific regulation because of the marginal economic importance of bitcoin. FINMA, in its official statements, also focuses mainly on bitcoin and has issued a corresponding factsheet that provides some regulatory guidance, but tries hard to create a palatable environment for innovative business models. For instance, in contrast to a view adopted in the factsheet, FINMA would not consider the safekeeping of virtual currencies in account deposits or a wallet as an activity requiring a banking license, as long as the private keys are deemed severable in a bankruptcy of the custodian. On the other hand, if the custodian was able to dispose of the virtual currency accounts without the beneficiaries' interaction, a banking license would still be mandatory.

Needless to say that a banking license would be much too expensive for a FinTech start-up to obtain. So far, Swiss law does not provide any license category with lower requirements for companies taking deposits or offering related services only. In other words, FinTech companies may not extend their license with the expansion and growth of their business.

Given that the Swiss financial industry finds itself in the middle of far-reaching technological change, and since a dynamic FinTech ecosystem may significantly contribute to the quality and the competitiveness of Switzerland's financial centre, the Swiss Federal Council decided to ease the regulatory framework for providers of innovative financial technologies in November 2016. As a result, the Federal Department of Finance (FDF) presented the so-called FinTech strategy Switzerland as a form of deregulation with three supplementary elements:

First, the deadline for holding (fiat) money in settlement accounts will be prolonged from 7 to 60 days. Second, a company may accept deposits in a total value of CHF1 million without the need for a banking license by FINMA (often referred to as sandbox). Third, a «banking license light» should be introduced which allows a company to accept deposits up to CHF100 million provided that the funds will not be invested nor subject to interest payments to the clients. This new license should be paired with a loosening on the licensing process, the account, auditing and regulatory capital requirements. Unfortunately, the implementation of this new license category has been shelved. It should now only be implemented with the Financial Services Act and the Financial Institution Act likely in 2019 (the Financial Services Act aims to introduce equivalent rules to the European Markets in Financial Instruments Directive). We have some doubts whether there will be demand for a license category which allows for holding but not investing money, though. We certainly would welcome if the National Council, which will debate the Financial Institution Act in fall 2017, will extend the permitted business activities of companies benefitting from this new option and turn it into a real FinTech license. Such FinTech license should, inter alia, allow for the creation and issuance of tokens against fiat money, investing in the creation of new protocols and having token holders benefitting from the returns without such payments being subject to Swiss withholding tax. If not structured properly, initial coin offerings (ICO) may trigger Swiss withholding tax of 35 per cent on payments to token holders should such ICO be deemed as collective fundraising under Swiss tax law. The first two deregulation elements to enter into force per 1 August 2017 will, in more detail, provide for the following:

Extended timeframe of settlement accounts

A first focus of the deregulation reform pertains to the extension of the timeframe for settlement accounts.

At present, credit balances on settlement accounts with the exclusive purpose of serving the settlement of client transactions, with no interest paid on the funds and provided that transfer is executed within seven days upon crediting of the funds, are not considered to be deposits under the banking regulation. Companies accepting funds for settlement on behalf of the clients do not require a banking license (but are subject to anti-money laundering rules). For many years it has been unclear how long client money may remain on the settlement account before being transferred to the beneficiary. According to the latest ruling practice of FINMA, the timeframe has been set to seven days as stated above.

As explained, the extension of the settlement timeframe to 60 days would represent a significant advantage mainly for crowdfunding /-lending platforms. Provided that they accept client money only within the extended timeframe, they should pre-sumably not be subject to the banking license requirement (which anyhow appears to be not unproportionate).

Sandbox

The second element of the regulatory reform approach is the creation of an innovation area or sandbox, e.g., the exclusion of certain activities from regulation which would otherwise require a license.

As explained above, a company may accept deposits from 20 clients or less without triggering banking license requirements. The new regulation will now no longer look at the number of clients but the value of client asset held by such company. In the event deposits of not more than CHF1 million are held by a company, no banking licence will be needed.

Interestingly enough, this deregulation opens more opportunities for lending platforms than for other FinTech companies. In the past, FINMA has ruled that a private individual would be deemed as a bank in the event he or she is taking out a consumer loan facing more than 20 investors which acquire a tranche of the loan via the lending platform. A lending platform could therefore split the loan among 20 investors only. From 1 August 2017 onwards, a participation of the loan among an unlimited number of investors will be permissible provided that the loan amount will not exceed CHF1 million.

It is noteworthy that the sandbox will only relieve from banking regulation but not from the requirement to comply with anti-money laundering regulation.

Remaining loopholes

We certainly welcome the proposed deregulation outlined above which should allow certain FinTech companies a smoother market entrance without the burden of regulation. Yet, the effects of the new rules will be rather limited and the introduction of a certain FinTech license has been postponed until 2019. FinTech is rapidly developing from crowdfunding and lending platforms to the issuance of cryptocurrencies on existing protocols or even on newly established protocols. The creation of coloured coins (ie storing additional data on the blockchain in order to attach "real world value" to the coin) and tokens which may allow a cost efficient and fast transfer of assets between any counterparties may overturn the existing inter-banking settlement system.

The qualification of cryptocurrencies and the classification of tokens as (intermediated) securities are not addressed by the new rules; neither are withholding or other tax matters on payments under the tokens. The proposed deregulations remain, therefore, a first step only. As in any area, the lawmaker regulates the past, not the future. Should Switzerland intend to play an important role in FinTech, we seriously have to reshape financial regulation and certain other aspects of the law (which includes insolvency law, data protection and tax law) to keep up with the challenges and opportunities of FinTech.

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