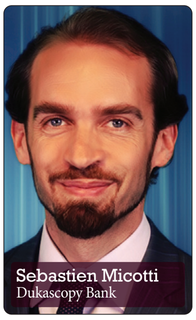
FOREX REGULATION IN SWITZERLAND

In April 2008 the Swiss authorities introduced new regulations governing the activities of forex dealers operating in the country. Sebastien Micotti and Gianluca Flammia of the Swiss banking group, Dukascopy, take a look at the impact of these regulations.



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Over the last three years regulatory oversight in most parts of the world, not to mention the global financial meltdown, has changed the landscape of what it takes to be a competitive forex broker/dealer (referred to hereinafter as "forex dealers"). Indeed, the forex dealer market is consolidating in regulated countries such as the US, Switzerland, Japan and many others.

In Switzerland, the authorities have not examined whether or not forex trading shall be deemed trading on a financial product or not. However, the approach taken by the Swiss regulator and government has drastically strengthened the regulatory framework for all forex dealers located in Switzerland since 2008. Indeed, a revised version of the Swiss Ordinance on Banks ("Banking Ordinance", the purpose of which is to implement the principles of the Swiss Banking Act), including new rules for forex brokers, came into force on 1st April 2008 (Article 3a, paragraph 3 letter c). We examine the basic principles of the regulatory changes and their impact on the industry below.

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Before April 2008

Before the aforementioned regulatory changes, forex dealers in Switzerland were considered professional financial intermediaries and as such subject to the Swiss Anti-Money Laundering Act which required their affiliation to a private anti-money laundering regulatory body (the latter supervised by the financial regulator) or to the Swiss Federal Banking Commission itself (SFBC – now FINMA, for Swiss Financial Market Supervisory Authority since January 2009) for anti-money laundering purposes only. There was no overarching regulation of forex dealers in Switzerland before then.

This situation was based upon an exception to the Swiss Banking Act, introduced in the 1990s by the government through the Banking Ordinance, further to which dealing with currencies was not considered a banking (and therefore regulated) activity. That particular regime was motivated by the fact that forex dealing was almost exclusively conducted by banks anyway (which was true in the mid-1990s) and was a marginal activity in the Swiss financial sector (limited to institutional and sophisticated wealthy clients of Swiss banks).

Technological advances in recent years have allowed new market participants to act as brokers both in the Swiss and worldwide forex industry, and easier access to liquidity has opened the doors of forex dealing to retail clients as well. With relatively limited investments, several stakeholders have been able to operate a forex dealing platform to act as market-makers for their clients, the Swiss regulator stated in a position paper in November 2007.

The main reasons for regulatory change

The steady increase in the number of forex service suppliers resulted in an increase in the number of complaints from retail investors to the Swiss regulatory authorities in respect of the activities of certain forex dealers (e.g. non-payment of gains, lack of transparency or lack of information regarding risks, possible Ponzi schemes, etc.).

This motivated the Swiss authorities to intervene in order to increase customer protection in the Swiss forex industry as well as improving the reputation and the interests of the Swiss financial sector, by amending the Banking Ordinance, thus removing the exception introduced in favour of the forex industry some 14 years previously.

In spite of the opinion of a substantial part of the industry in Switzerland the Swiss authorities preferred from the beginning not to pass a specific regulation for forex dealers due to their globally relatively minor importance for the Swiss financial sector. Considering that forex dealers mainly presented similarities with banks (acceptance of margin deposits from customers) as well as with securities dealers, Swiss authorities decided to use the existing framework of prudential regulation and to encompass forex dealers in one of the previously existing licence categories.

As the Swiss financial sector is subject to only two different main categories of licence (banks and securities dealers), the alternative was to submit forex dealers either to banking requirements under the Swiss Banking Act or to the regime applicable to securities dealers further to the Swiss Stock Exchange Act (SESTA). However, although favoured by some, the submission of forex dealers to the SESTA was rejected by the competent authorities. This was because it would have been necessary to extend the definition of "securities" under Swiss law which would then have required a full review of the SESTA and its implementation ordinances. Another reason for the authorities opting for a banking license instead of a securities dealer licence was the fact that forex dealing was at that time principally performed in Switzerland by banks and not by securities dealers.

With this modification in place, all forex dealers accepting deposits directly from customers on a global bank account opened in the dealer's name, receiving and executing orders from customers either directly or via external money managers and acting as counterparties to customer transactions, have been obliged to apply for a banking licence according to Swiss law in order to be authorised to carry on their activities in and from Switzerland. Forex dealers in business as of 1st April 2008, who filed their applications on time with the regulator, were granted an additional one year extension either to fully comply with the Swiss Banking Act or to cease any forex dealer's activity in and from Switzerland.

Consequences of the new regulation

The new conditions imposed on the Swiss forex industry had, and still have, major repercussions on forex dealers, obliging them to completely review their internal organisation structures and make sometimes significant investments to comply with banking standards. Being a bank in Switzerland requires sufficient capitalisation according to the type of activity to be conducted and products offered – which in practice sets the lower threshold to CHF 20 million.

Out of around 30 forex dealers acting as direct counterparties to customers (market makers and/or ECN) in Switzerland in November 2007, only three eventually filed an application to conduct banking activities with FINMA. Two of them were granted the appropriate licence while the third was acquired by an existing bank after having received a negative decision from the authorities. Many other forex dealers were closed down by the regulator – some moved to other jurisdictions such Cyprus and Malta or reorganised their activities.

Two years after the regulatory changes only those who have demonstrated their full compliance with all banking requirements have been authorised to continue operating in and from Switzerland. The relatively long period of thorough investigations by FINMA and external auditors was an opportunity for the successful newly-licensed Swiss forex brokers to make further improvements, mainly in terms of technological solutions and to prepare to broaden the range of products offered to customers. The improvements also offer additional comfort to the regulator and project a better image which serves to improve the retail forex industry's overall reputation.

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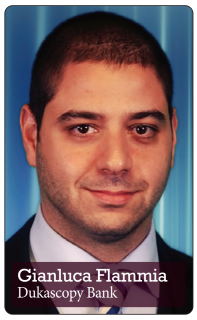

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