SWITZERLAND
THE CRYPTO NATION

Special report on Fintech in Switzerland

BREXIT AND CROSS-BORDER REGULATION

Covington take a look at the BREXIT effect on Cross-Border Regulation
Welcome to the latest edition of InCiDA.

Uncertainty still abounds over the future relationship between the United Kingdom and the European Union. Whether a resolution can ever be found and what the knock-on effects of this are likely to be is something upon which we can only speculate. The British have traditionally preferred satire to revolution, but as the political handling of the crisis descends further into farce this may yet change.

At ICDA we are electing, instead to turn our attention to the growth of Fintech in Switzerland in a special feature of the topic, Covington tackle the thorny issue of the Brexit effect on cross-border regulation, and there are many more news and views contained inside.
Happy reading!
THE LATEST BREXIT CHAOS - WHAT DOES IT MEAN FOR DERIVATIVES MARKETS? - PART ONE OF A FOUR PART SERIES

The past several months have been chaotic for both Brexit negotiations and UK politics overall. The UK’s departure from the European Union (“EU” or the “Union”), originally slated for March 29, was pushed back to April 12 and then again to October 31, 2019. What form Britain’s exit from the EU will take is unknown and all options remain on the table, including not leaving at all, and leaving without a formal withdrawal agreement in place.

The derivatives industry, largely due to London’s role as a global hub for derivatives, has become a flashpoint between the UK and EU during these negotiations. For months now investors and advisors, particularly those in the UK, have been flagging concerns about the impact of Brexit on the derivatives industry. London and New York sit at the center of the world’s multitrillion dollar derivatives market, with the UK and US controlling 80% of the $594 trillion-a-year business — notionally worth more than five times the global GDP. About a third of the derivatives contracts traded in the UK every year come from US companies, more than any other jurisdiction.

Regardless of the realpolitik tumult caused by a possible Brexit, derivatives markets, with their outsize impact on risk management, must still function. Over the past few months, the European Commission (the “EC” or the “Commission”), the UK government and even the U.S. Futures Commodity Trading Commission (“CFTC”) have taken steps to mitigate the negative impacts of the UK’s shambolic divorce from the EU. Despite their best efforts, issues and market concerns remain. In Part I of this four part series, we discuss what has been achieved so far to address issues of equivalence surrounding clearinghouses.

THE EU RELUCTANTLY PROVIDES RELIEF FOR CLEARING HOUSES

UK’s Financial Conduct Authority (the “FCA”) has warned of fragmented markets and liquidity shortfalls if the country exits the EU without a formal withdrawal agreement in place, an increasingly likely prospect. Reduced liquidity would increase trading costs and make it more difficult to execute large transactions. Facing such risks to the derivatives market and attendant long-term impacts on the economy, the EC announced on December 19, 2018, that it would adopt an equivalence decision to address some, but not all, of the issues associated with a no-deal Brexit.

The decision stated it will issue temporary licenses to clearinghouses, recognizing UK laws as “equivalent” to EU standards, to ensure that derivatives markets will continue to function with minimal disruption. On February 18, 2019, the European Securities and Markets Authority (“ESMA”) awarded such licenses to London’s biggest clearinghouses — LCH Ltd., ICE Clear Europe and London Metal Exchange’s (“LME”) LME Clear. The licenses enable the clearinghouses to settle derivatives trades for investors and companies based in the remaining 27 EU countries.

The impetus for clearinghouse recognition was the fundamental issue of access to clearing services for European firms. The European Market Infrastructure Regulation (“EMIR”) requires firms to clear mandated swaps at recognized central counterparties (“CCPs”) or clearinghouses. Without recognition or equivalence in a no-deal Brexit, EU clients would be cut off from London-based clearinghouses, including the three institutions previously mentioned, which are the most important clearinghouses, globally.

Despite the absolute necessity for relief, the December decision set forth stringent conditions for granting such temporary “equivalence” and subsequent market access to EU customers, saying the bloc’s regulators must be able to see the inner workings of clearinghouses in a non-EU country. In other words, ESMA should have access to “all information requested” on an “on-going” basis. The exchange of information includes sensitive matters, such as setting margins or how much cash customers must post to collateralize their trades, and how “calibrated” such clearinghouses are in a crisis. Continued clearing approval is dependent upon certain requirements being met.

It is important to understand the fraught geopolitical background against which these additional requirements have been introduced. Politicians in the remaining 27 EU countries have always been uneasy with how much of Euro-based derivatives clearing takes place in the UK. London’s LCH Ltd., alone, clears more than 95% of euro-denominated interest rate swaps. US regulators have been equally uneasy about such a large portion of the dollar market being located outside of the US, but have

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It is well known that Switzerland is a world leader and an innovator in the financial services sector. The Swiss financial services industry was built on a solid foundation that stands today as home to some of the largest and most trusted financial services companies and institutions in the world.

It is with this rich history and foundation that Switzerland will continue to be a world leader even as technology makes its presence in the financial services sector.

As the world becomes more technologically dependent, Switzerland is ahead of the power curve in making Fintech readily available to a wider group of people who might not have access to traditional financial services.

There is no doubt, Fintech is here to stay. Even though many thought it would not be a serious competitor for traditional services. Not only is it here, but it is thriving. We are seeing large international traditional financial service companies such as JP Morgan and Goldman Sachs, fully embracing and investing in Fintech.

WHAT IS FINTECH?

Financial Technology (FinTech), is described as new technology that seeks to improve and automate the delivery and use of financial services. These are new applications, processes, products, and business models, composed of one or more complementary financial service and provided as an end-to-end process via the internet.

It is through this new technology and the use of smartphones for mobile banking, investing services, peer-to-peer lending, robo-advising, insurance, and cryptocurrency that are making financial services more accessible to the general public.
WHAT IS DRIVING FINTECH?

With customer demographics changing, the services and methods needed to attract and serve the young tech-savvy millennials needed to change. The traditional past practice of a customer walking into a financial services institution and sitting down with a customer representative, seems to be more and more something of the past.

These young individuals known as Generation Y, born between 1980 and 2000, are looking for and expect technology to help them navigate complex financial decisions from their cellphone.

It seems that the institutions that reach out to this demographic through Fintech, whether it be a traditional financial services company or an entrepreneurial new start-up, will be the winner.

Traditional financial service companies are poised to be successful in attracting new clients as they already have name recognition, experience and trust and can implement Fintech applications to reach Generation Y.

While at the same time, Fintech entrepreneurs are creating more options which the traditional financial institutions are not serving, many times in a quicker and cost-efficient manner to reach Generation Y.

FINTECH IN SWITZERLAND

As with new innovations, there are always challenges which stand in the way. Especially when the new innovation is seen as disrupting the status quo. Initially, Fintech was seen as a “disruptor” to traditional financial services.

There were concerns that these new financial service providers, were not “real” financial service providers but just tech firms. They were not properly licensed as traditional providers were required.

An additional concern was how will these new “tech” services which are providing new “financial services” be regulated.

In order to address these concerns, the Swiss government and regulators took it upon themselves to provide the proper infrastructure, support and oversite for Fintech to thrive.

Though Switzerland has no specific fintech regulation, the rules which apply to traditional financial services also apply to fintech. It doesn’t matter whether they are using traditional or innovative technological means.

Because of this stance, the Financial Market Supervisory Authority (FINMA) and the Swiss government worked to insure Fintech start-ups were playing within the rules. Additionally, the Swiss Parliament passed key legislation which helped make it easier for them to develop and provide services similar to traditional financial service companies.

The results of this support are paying off. An April 1 2019 Study prepared by the Lucerne University of Applied Studies, showed the Swiss fintech sector growing, while traditional financial institutions are stagnating.

It is because of this governmental and regulatory oversight, 10% of all global European fintech companies are located in Switzerland. That is amazing, considering that this tiny country is making such a mark in the future of financial services.

FINTECH FUTURE IN SWITZERLAND

The financial services industry has long been a part of the DNA of Switzerland, just as much as chocolate, cheese and watches. With this long and strong history, government and regulatory support, great universities and Swiss brain power, Switzerland will continue to grow as a Fintech leader in Europe and the world.

“Switzerland has positioned itself as a hub for blockchain related activities. This success will be maintained if Switzerland welcomes innovative and serious projects.”

Mark Branson of FINMA

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Whilst many remain sceptical with regard to ICOs, and some regulators openly hostile (notably China and South Korea who have banned ICOs), the Swiss government sees their potential. ICOs in Switzerland account for about 13% of the total amount raised since 2014, the highest in Europe, although still a long way behind the US, the world leader, with a staggering 38%. Switzerland is also forging a path in terms of the regulation of this sector.

Johann Schneider-Ammann, economics minister said that Switzerland wanted “to be the crypto nation.”

ZUG – CRYPTO VALLEY

The beautiful lakeside city of Zug has roots which stretch deep into the history of the Swiss confederation and beyond. In more recent years the Canton’s low corporation tax have made it an attractive location for many multinational enterprises and the city and its environs boomed, placing Zug firmly on the commodity trading map, with the Guardian newspaper going so far as to describe it as ‘a compass of the global economy.’

Today the map is being redrawn yet again as there has been a massing of blockchain and other crypto-technology companies in and around the town. (What is the collective noun for fintech companies? A ‘hash of fintech start-ups’? Suggestions on a tweet please -Ed. @incodaorg). To date there are more than 500 blockchain start-ups including established stars such as Ethereum.

Zug has recently become one of the first municipalities to accept payments in Bitcoin. ‘Crypto valley’ as the area has become known is regularly compared to the long-established centre of innovation in California, Silicon Valley. A far cry from its early days as a fishing village, the name ‘Zug’ refers to the action of pulling up the nets, this fairytale Swiss town is now casting its nets rather wider.
IN A NUTSHELL:  
THE SWISS FORMULA

From St Ives facial scrubs to the Swiss approach to WTO tariffs negotiations, branding anything with the words ‘Swiss Formula’ is guaranteed to pique interest. Here we set out the ingredients of the Swiss formula which are driving it to the forefront of global fintech.

Regulations: Typically the Swiss take a very pragmatic, business-focused approach to regulations.

On January 1st 2019 a new license type became available to fintech companies established in Switzerland. The so-called ‘Fintech Authorization’ was introduced as an amendment to the Swiss Banking Act on June 15th 2018.

In summary, if the amount of clients’ funds accepted or handled by a FinTech company remains, on average, under 100 million CHF, such company is eligible for a lighter regulatory regime, and most importantly, lower capital requirements.

Investment: There is plenty of money sloshing around in Switzerland and the tide of this wealth has definitely turned towards fintech. In 2018 a total of CHF 685 million was invested in ICT and fintech start-ups. For the first time financing of the information and community technology and fintech sectors outstripped investment in life science companies.

Stability: The relative stability of the Swiss economy makes it an attractive proposition for those looking to invest in new ventures or expand innovative projects (can’t help but reflect on yet another example of a certain universal irony that it is the very stability of Switzerland which makes it such fertile ground for so-called disruptors!)

Talent: There is a close co-operation between the industry and the many excellent universities and institutes of higher education which Switzerland boasts. The steady stream of available new talent promotes innovation throughout the entire sector.

Legacy: The old guard of the Swiss financial centres are working in partnership with the arrivistes with more than 75% of Swiss companies planning to introduce blockchain applications over the next 3 years.

The Swiss Formula for fintech is, according to FINMA, to “increase legal certainty, maintain the integrity of the financial center and ensure technology-neutral regulation...to help to ensure that Switzerland remains an attractive location in this area.”

GLOBAL FINTECH RANKINGS (CITIES)

1. Singapore
2. Zurich
3. Geneva
4. London
5. Amsterdam

An estimated 10% of all global European fintech businesses can be found in Switzerland

Of the top 5 global cities for Fintech innovation, 2nd and 3rd place go to cities in Switzerland
A patron member of ICDA, Covington provides global regulatory and market expertise in addressing the full range of issues implicated by cross-border derivatives markets. Covington’s international team advises clients on enforcement and internal investigations, regulatory advocacy, compliance policies, and corporate transactions.

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DEMOCRACY versus ECONOMICS

“MAY YOU LIVE IN INTERESTING TIMES” SO THE POPULAR TRANSLATION OF THE FAMOUS CHINESE CURSE GOES.

Leaving aside the rather unfortunate pun at the beginning of the malediction, it can certainly be said that these are interesting times indeed.

Another oft-touted piece of Chinese wisdom is that within the Chinese alphabet the character which represents ‘crisis’ also represents ‘opportunity’. Talking of character within this context, one has to reflect that if the parallel meaning of opportunity, or the notion that opportunity can be drawn from a crisis pre-supposes a certain level of character - that is an attitude comprised of fortitude, resilience, imagination, flexibility and determination - to enable this to happen.

A celebration of character has long been implicitly enshrined in democracy in the sense that democracy is a validation of the individual and the individual’s right to choose who governs them, and therefore how the country is run. In a democracy, so the theory goes, the people get the government they deserve. Would that were true when 80% MPs presently serving in the British House of Commons have been elected on manifestos which promised to honour the result of the Brexit referendum, and yet most of them seem to be doing everything they can to thwart the process of leaving. The more they drag it out, the more distant the 2016 vote becomes, the more comfortable they feel in reframing their notion of what honouring the result means.

The main argument put forward as part of the rationale to justify the actions of those who would seek to deny the result of the referendum is that the people ‘didn’t know what they were voting for’. Are we therefore

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suggesting that anyone who doesn’t have more than a salutary understanding of the potential commercial and economic implications of a particular political or fiscal policy should not be allowed to vote at any election? Or has every election hitherto this referendum been conducted in an atmosphere of perfect understanding and foresight? Regardless of which lies were told by when and by whom, for the last thing one wants is to get caught in the mudslinging crossfire, one is uncomfortably reminded of George Bernard Shaw’s ironic assertion in his introductory essay to Saint Joan that the cardinal vice of democracy is the election of the superior by the inferior.

Of course, he meant this statement as a criticism of the prevailing attitudes of a ruling class who preferred to keep the reins of power firmly in the hands of a select few. Shaw, an ardent campaigner for women’s suffrage and social reform, abhorred hypocrisy in all its many forms and certainly preferred the model of democracy to its alternative even if it meant substituting ‘election by the incompetent many for appointment by the corrupt few.’

‘People didn’t vote to be poorer,’ is one of the more emotive one-liners which MPs have recently trotted out to mitigate the risk of them being accused of being anti-democratic. The assertion that the risk to the economy is too grave is the one which makes those intent on stopping Britain from quitting the E.U. feel on firmest ground for the building of their case. But it is not only in the Brexit debacle that democracy has been considered to be injurious to economic growth. In fact, the argument over which political model is the most economically fruitful dates all the way back to Plato and Aristotle.

Throughout history there are, indeed, examples of powerful economic performance in the absence of democratic freedom. In the 1980s, whilst many democratic countries struggled against recession, Chile apparently thrived under the dictatorship of Pinochet. The success of other autocratic, although more benign regimes can be seen in the emergence of Singapore as a global power under Lee Kuan Yew. More recent examples exist in the astonishing growth of China and the Chinese Communist party’s ability to traverse the difficulties which have stymied many another

In refutation of the notion that democracy inhibits economic growth, the World Economic Forum have produced a number of studies which illustrate that many countries moving from an autocratic to democratic system demonstrate considerable growth “about 20% higher GDP per capita in the long run.” But looking at things ‘in the long run’ is somewhat unfashionable at the moment. The desire to give up an essential freedom for a temporary security is disturbingly widespread. Rantings against the ‘failing of democracy’ and politicians talking about ‘the tyranny of the majority’ should be ringing alarm bells as loud as air-raid sirens in any properly-thinking individual. Democracy may be flawed, but it is an awful lot better than the alternative. Whilst we are on the subject and as so many people seem to be so keen to quote (and flagrantly misquote, or de-contextualise) Churchill at the moment, here is another one from him;

“Democracy is the worst form of government, except for all those other forms that have been tried from time to time.”

Whether democracy is good or bad for economic growth, and indeed, whether the result of a democratic vote has unforeseen or unpleasant economic implications, arguments about economic security should never be allowed to undermine the fundamental and long-fought for principles of democratic freedom. The cost of that would be incalculable.
The see-you-and-raise-you discourse between the EU and the US continues with Trump now threatening new tariffs on many European goods (chiefly; aircraft, cheese and wine). The U.S. president has threatened to impose US tariffs on $11bn (£8.4bn).

In response to EU subsidies given to Airbus, which WTO has acknowledged caused “adverse effects to the United States.” With markets already becoming jittery and the growth of the Eurozone decelerating, the heightening of tensions between these two superpowers is not doing anything to boost investor confidence.

TOP TRUMPS

Having assiduously avoided the dreaded ‘B’ word for this edition of Bitesize we must reflect that whilst chaos reigns in Blighty, a transatlantic front in the battle over derivatives regulation has opened up which sees the United Kingdom caught between EU protectionism and US pragmatism, all of which has been brought sharply into focus by the question of the clearing of Euro derivatives in London after Brexit. Conceding that this business will likely be largely still centred in London when (if?) Britain leaves the EU, ESMA has been seeking to establish more intrusive control which covers “both EU and third-country CCPs). The US regulatory authorities, of which the CFTC is the most vocal, are deeply uncomfortable with this, concerned about potential encroachment on the dollar markets. Chairman Giancarlo made these feelings very clear when he stated that the Americans would not hesitate to follow “a range of readily available steps to protect US markets and market participants”.

MONEY, MONEY, MONEY

Whilst the Trump administration is putting pressure on the US Federal Reserve to ease monetary policy to boost financial markets, the IMF counsels against short-term growth policies which could increase the risk of a new financial crisis.

BITESIZE

PIGGY-IN-THE-MIDDLE

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PIGGY-IN-THE-MIDDLE
accepted the status quo because UK authorities gave the CFTC sufficient oversight over their clearinghouses, particularly the LCH Ltd. dollar business.

The fact that ESMA will now directly monitor such clearinghouses has put at risk the fragile détente between the UK, US and the EU. The CFTC has already told Europe that it will not accept ESMA controlling London’s swaps business so long as it impinges on dollar markets and US banks. Beyond the argument that such oversight would infringe upon US sovereignty, there is an ideological rift between regulators, with the UK and the US on one side and the EU on the other. UK and US regulators tend to rely on market forces and believe private sector entities can effectively determine how much collateral market participants must post against trades to cope with default risks. European regulators, on the other hand, do not believe market forces should determine the collateral levels during a crisis. Their view is largely informed by the fact that, during the 2011 sovereign debt crisis, entities such as LCH Ltd. imposed margin calls on Spanish and Italian assets. In the view of European regulators, such efforts escalated the crisis. In the eyes of US and UK regulators, such margin calls were prudent risk management.

After announcing its plan to address the issue of European clearing in the short term, the EU also promised to set forth permanent rules for clearing by 2021. The CFTC and Brussels announced that the CFTC will participate in such preparations. Until the EU unveils its rules in 2021, it is unclear how clearinghouses in London will adhere to ESMA principles for clearing when Brexit (in whatever form) occurs. The uncertainty is not as troubling when markets are calm but could be catastrophic if another crisis hits and the volume of margin calls increases.

The real battle between the US and Brussels has only been delayed until 2021. The US continues to believe that ESMA should not regulate London’s dollar business. The CFTC has repeatedly stressed that its authorization of the Eurozone’s biggest clearinghouses is based on existing agreements and can be rescinded.

CLEARINGHOUSES: THE TIP OF THE ICEBERG

All Brexit-related negotiations have been intensely political. The EU’s equivalence decision applies only to the most systemically pressing concerns and does not provide a market-wide solution. There are a number of issues that derivatives market participants will have to grapple with as Brexit negotiations continue to bumble along, including, but not limited to, (1) how UK-based exchanges will achieve recognition in the EU27; (2) without regulatory passports how UK entities will interact with clients in the remaining 27 EU member states, generally; (3) how relief with respect to novations will be implemented in the case of a no-deal Brexit; and (4) how firms operating in both the UK and the EU will implement two separate reporting systems to remain in compliance with diverging regulatory regimes.