

Scope and Rules of Conduct - Consultation for FIDLEG and FINIG - Part I

The Swiss government opened a consultation process for the draft bills of a Financial Services Act and a Financial Institutions Act. These two projects will completely reshape the regulatory framework governing the Swiss financial markets. It includes new rules of conduct for financial intermediaries, a regulatory regime to prepare a prospectus in connection with public offerings of securities, registration obligations for client advisors and foreign service providers, licensing obligations for asset managers, as well as comprehensive rules aiming to facilitate access to justice, including through a form of class actions.

The consultation process runs until 15 October 2014. The Federal Council plans to send the bill of the Financial Services Act and the Financial Institutions Act to parliament in Q2 2015.

In this first briefing on the draft bills, we examine the scope of FIDLEG and the proposed regulation for rules of conduct for financial intermediaries.

Scope: Financial Services

The draft FIDLEG aims to regulate **all types of financial services** that are provided on a professional basis in Switzerland or to clients in Switzerland, including

- acquisition and sales of financial instruments,
- transmission of orders relating to financial services,
- investment management and investment advice,
- custody and holding accounts,
- extending credit in connection with transactions in financial instruments.

This **broad definition of financial services** and in particular of investment advice is likely to encompass

many lines of business that were until now largely unregulated, including portfolio management and investment advice, which could be construed to apply to many corporate finance-related services, such as mergers & acquisition advisory and arranging and structuring securities offerings.

By contrast, the draft FIDLEG does **not cover credit-related transactions** (to the extent they are not carried out in connection with transactions in financial instruments) and **traditional insurance and reinsurance services** that are not tied to transactions in financial instruments.

The draft FIDLEG will apply to services provided to **all types of customers** and cover services offered to retail and sophisticated investors alike, although it provides for a different level of protection for private

investors, professional investors and institutional investors and allows investors to opt out of or into different levels of protection, as is already the case in connection with collective investment schemes.

Rules of Conduct

The cornerstone of the draft FIDLEG is a comprehensive set of rules of conduct. These rules include a duty to inform clients and to ensure that services and products offered are **suitable or appropriate** for them, as well as an obligation to **ensure best execution**. To ensure the effectiveness of the rules of conduct, the draft FIDLEG backs the rules of conduct with **extensive documentation and reporting duties**.

Information Duties

Under the draft FIDLEG, all financial service providers will be subject to **extensive disclosure duties**. They will need to disclose, among others:

- their identity and regulatory status,
- the services and financial instruments they offer,
- how they custody financial instruments,
- the risks and costs associated with these services, instruments and custody, and
- that clients have recourse to the Ombudsman to resolve disputes.

In connection with **asset management and investment advice**, financial service providers will also be required to disclose

- whether they act independently or limit their offering to financial instruments issued by specific institutions;
- whether or not they will provide their services on an ongoing basis,
- whether they will be carrying out any market analysis of the products offered.

The information required by the draft FIDLEG can be provided in a standardized form.

Finally, financial service providers will be required to provide free of charge the **basic information document** in connection with any offer of financial instruments, which are subject to this requirement, (including the basic information document of any underlying instrument) and, on request, the **prospectus** relating to such instruments.

Suitability and Appropriateness

Codifying existing requirements under contract law and taking them one step further, the draft FIDLEG contemplates obliging as a regulatory matter **investment advisers and investment managers** to ensure that the services and instruments they offer are **suitable** for their clients.

Thus, investment advisers and investment managers will be required to **know their clients' financial situation and investment objectives** as well as their **knowledge and experience** and to determine on the basis of this information whether the services and instruments they offer are suitable.

All **other service providers** will be required to ensure that the service or instrument is **appropriate for the client**, *i.e.* whether the client has the **requisite knowledge and experience** to use such services or invest in such products, without considering their financial situation and investment objectives.

If clients do not meet these requirements, the financial service providers are **required to warn** their clients, but may let their client carry on with the investment. By contrast, if investment managers and investment advisers consider they do not have the requisite information to ensure the suitability, they **are barred from servicing the client**.

Exceptions and Exemptions

The draft FIDLEG provides for exceptions to this obligation to ensure suitability or appropriateness **only in connection with execution-only services** at the initiative of the client and financial intermediaries whose services are limited to holding

accounts taking **custody of financial instruments** and forwarding orders.

Notably, this regime will also **apply to services provided to professional and institutional clients**, although in a slightly milder form. With respect to these more sophisticated clients, financial intermediaries may assume that clients have sufficient knowledge and experience as well as the capacity to bear the risks when assessing suitability or appropriateness.

Best Execution and Restrictions on the Use of Financial Instruments

Over and above the rules of conduct, financial service providers are required to handle client orders in good faith and in line with the principle of equal treatment.

This duty applies in particular in connection with the **best execution obligation**, which requires service providers to ensure that they provide their clients the best execution, taking into account financial terms, speed and qualitative factors. Firms will moreover be required to **implement internal policies on how to execute client orders**.

The general duty to act in good faith also comes to bear in connection with the **use of financial instruments of clients**. The draft FIDLEG, which aims to codify certain aspects of existing regulations, allows financial service providers to engage in securities lending with client assets only

- if the client expressly empowers them to do so in a written document that is separate from the general terms and conditions, and
- on a fully collateralized basis.

Documentation Duties

The rules of conduct are backed by an **extensive documentation duty**. Under these rules, financial service providers are required to document in writing

- what services they agreed to provide and the information they collected on their client,
- any information and warning they gave their client under the suitability and appropriateness rules,
- the services provided to the client, including in connection with portfolio management and investment advice,
- the needs of the client, and
- reasons for any recommendation to acquire or sell a financial instrument.

The documents collected in this context must, upon request, be **provided to clients free of charge**.

Furthermore, service providers are required to **account to their clients on transactions** carried out on their behalf, the composition, valuation and development of their portfolio, as well as the costs associated with the services.

Organisational Duties

In addition to the substantive rules of conduct, the draft FIDLEG proposes **organizational measures** that will need to be taken by financial service providers to ensure compliance with these duties.

In addition to a general obligation to have an appropriate organization, financial service providers are specifically required to ensure that both their **employees and any third party** they instruct have **appropriate qualifications, knowledge and experience** to discharge their duties.

Moreover, the draft FIDLEG contemplates a duty to **ensure compliance within a chain of service providers**: if a service provider instructs another service provider to carry out an order, it remains responsible to ensure that the rules of conduct are complied with. On the other hand, down the chain, any service provider instructed in such circumstances may rely on the instructing service provider to comply with such duties and is required to ensure that they are complied with only if it has found reasons to believe that these duties were not or insufficiently complied with.

The draft FIDLEG is also used as an opportunity to provide for a statutory basis for the obligations imposed on financial service providers to **monitor their employees' transactions for their own account**, which was until now deduced from the general fit and proper requirement and implemented by the FINMA-Circular 13/08 on Market Conduct Rules.

The draft FIDLEG also seeks to tackle **conflicts of interest** and, more particularly, conflicts of interest arising out of distribution fees, trailer fees or any other types of **retrocessions**, which are mainly dealt with under the draft FIDLEG through organizational measures and disclosure. Namely, the draft FIDLEG permits retrocessions only if the client accepted explicitly to waive his right to receive such advantages or if they are completely handed over to the client. Thus, the draft FIDLEG stops short from an outright ban of such advantages, but codifies the existing case-law developed by the Swiss Supreme Court.

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