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FinSA: Scope, Client Segmentation and Rules of Conduct

On 15 June 2018, the Swiss parliament adopted the Swiss Financial Services Act (FinSA) and the Swiss Financial Institutions Act (FinIA). On 24 October 2018, the Swiss Federal Council opened a consultation process regarding the three ordinances implementing these acts, the Financial Services Ordinance (FinSO), the Financial Institutions Ordinance (FinIO) and the Supervisory Organisation Ordinance (SOO), which will last until 6 February 2019. The two acts are expected to enter into force together with the ordinances on 1 January 2020 and will introduce an entirely new regulatory framework governing the Swiss financial markets.

The FinSA will have a particular impact on financial service providers. In this briefing, we examine the scope of the FinSA and the new regulations governing the conduct of market participants.

Purpose

The FinSA aims to strengthen investor protection, create a level playing field for financial institutions and align Swiss laws with the European regulatory framework, in particular MiFID II and the EU Prospectus Regulation.

Scope: Financial Services and Financial Service Providers

The FinSA applies to financial service providers, defined as persons providing financial services commercially in Switzerland or for clients in Switzerland, regardless of whether they qualify as a financial institution under the FinIA or are a bank. However, pension funds, including employer sponsored pension funds, employers who manage the assets of their pension funds, as well as insurance companies and insurance brokers to the extent their activities are regulated by insurance supervisory law are, among others, expressly exempted from the scope of the FinSA. Persons providing financial services are subject to the act only if they do so on a commercial basis. FinSA defines a **commercial activity** as an independent economic activity pursued on a permanent, for-profit basis.

According to the legislative materials, the **term 'financial service'** is **defined broadly**, and covers all activities that could lead to the acquisition of a financial instrument by a client. Financial instruments are in turn defined to include equities (incl. participation certificates, dividend rights certificates, convertible bonds) and debt securities, derivatives, units in collective investment schemes, structured products, and certain types of deposits.

In particular, FinSA regulates the following **types of financial services**:

– acquisition or disposal of financial instruments,

– receipt and transmission of orders in relation to financial instruments,

– administration of financial instruments (portfolio management),

– provision of personal recommendations on transactions with financial instruments (investment advice),

– granting of loans to finance transactions with financial instruments.

Other credit related activities that are not related to transactions with financial instruments do not constitute financial services. Therefore, mortgage lending, commercial credits and consumer finance will not constitute financial services. Similarly, investment services related to direct investments in real estate, social security claims as well as occupational pension assets, do not qualify as financial instruments according to the dispatch. Similarly, investment services related to art, antiques or jewelry do not constitute financial services.

Overall, some degree of uncertainty remains about how broadly financial services will be interpreted. In particular, while market research and financial analysis will not be covered under the definition, since they will not lead to personal recommendations, it is not certain whether corporate finance services, *e.g.* underwriting, advisory services in connection with capital market transactions or mergers and acquisitions, will also be included in the definition. Similarly, it is not yet clear whether issuers of financial instruments, potentially even corporate issuers, will be deemed to be engaging in the professional sale of financial instruments.

Client Segmentation

The FinSA introduces a client segmentation regime. The classification under the FinSA plays an important role for the application of the rules of conduct. Indeed, depending on the client's classification, the financial service provider must offer **different levels of client protection** under the rules of conduct and the product information rules. Alternatively, a financial service provider may opt to forego the classification of its clients, but needs to treat all of its clients as retail clients.

Under this regime, financial service providers must categorize their clients into one of the following segments: **retail clients, professional clients** and **institutional clients**.

– **Professional clients** are defined as: (1) financial intermediaries in the meaning of the Banking Act (BankA), the Collective Investment Schemes Act (CISA) and the FinIA (including portfolio managers and trustees), (2) Swiss regulated insurance institutions, (3) foreign financial intermediaries and insurance institutions subject to a prudential supervision, (4) central banks, (5) public entities with professional treasury operations, (6) pension funds with professional treasury operations, (7) companies with professional treasury operations, (8) large companies that reach at least two of the following thresholds (balance sheet of CHF 20 million, turnover of CHF 40 million or equity of CHF 2 million), and (9) private investment structures with professional treasury operations set up for high net worth individuals.

– **Institutional clients** are a defined subset of professional clients and include the categories (1) to (4) listed above, as well as national and supranational public entities with professional treasury operations, but not cantonal or municipal public entities.

– All other clients will be defined as **retail clients**.

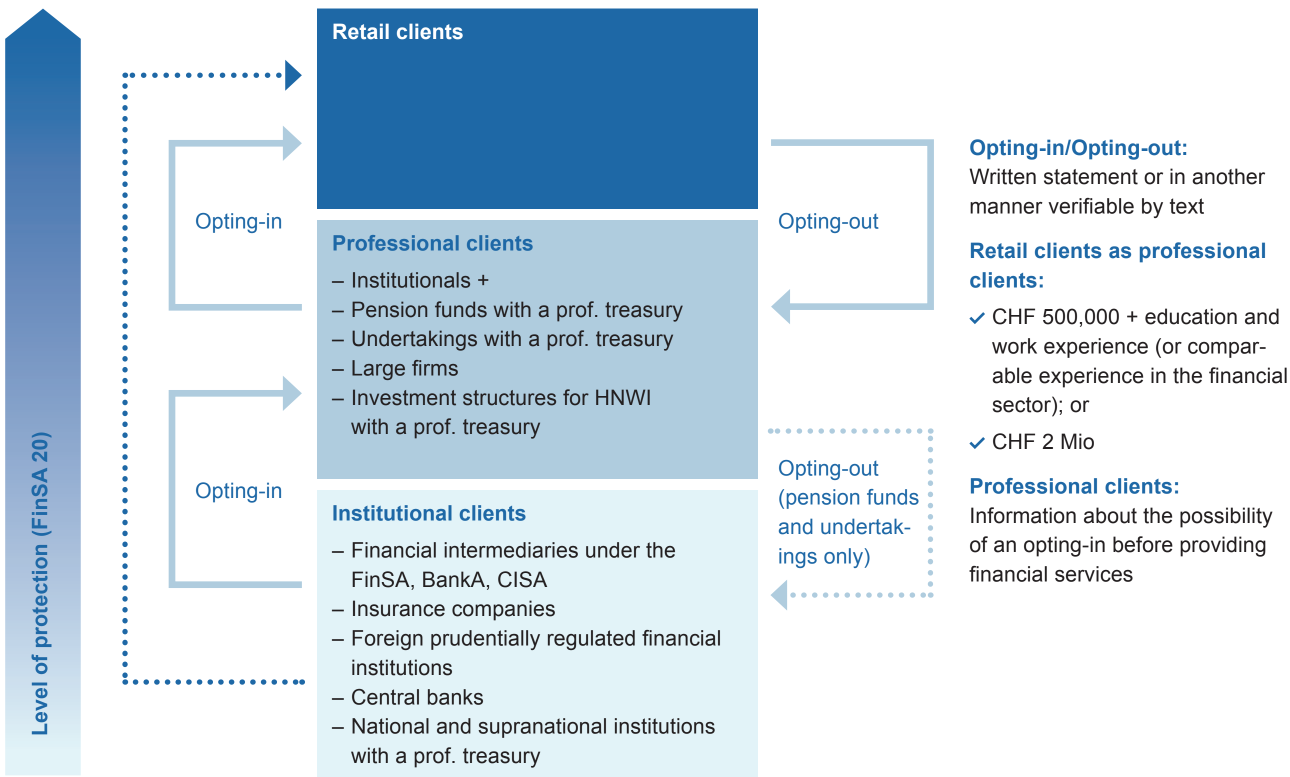
Certain clients have the ability to waive certain client protection provisions (**opting-out**) or to declare their intention to benefit from a higher level of protection (**opting-in**):

– **High net worth individuals**, who credibly declare that they either have the requisite education and professional experience and a net worth of at least CHF 500,000 or, regardless of their education and experience, have a net worth of more than

CHF 2 million will have the ability to opt out of the protection afforded to retail clients and request to be **treated as professional clients**. The draft FinSO clarifies that high-net-worth should be determined on the basis of financial assets but with the exclusion of direct investments in real estate and assets held in occupational pension plans. According to the draft FinSO, persons jointly owing the aforementioned funds can only declare an opting-out by acting together. Furthermore, in the case of common funds the draft FinSO provides that the requisite education and experience must be allocated to at least one person; and this person must be able to dispose of the net worth.

– Similarly, **certain professional investors**, such as pension funds and companies with professional treasury operations and Swiss and foreign collective investment funds and their management companies will have the option to elect to be **treated as institutional investors**.

– Conversely, **professional investors** that do not qualify by law as institutional clients may elect to be treated **as retail investors** and **institutional investors** can opt to be treated as professional clients only, but will not have the option to be treated as **retail investors**.



Pursuant to the draft FinSO, clients may request in writing (or another manner verifiable by text) to be classified on the basis of the knowledge and experience of their authorized representative. This opens the possibility for high-net-worth individuals who have a net worth of more than CHF 500,000 but do not reach the higher threshold of CHF 2 million to nevertheless opt-out from their status as retail investors and move into the segment of professional investors.

Before providing any financial services, financial service providers have to inform their professional and institutional clients of the potential to opt-in. Furthermore, a waiver or declaration to opt-out or opt-in must be lodged in writing or in another manner verifiable by text.

In parallel, the client segmentation rules of the CISA, *i.e.* the division into qualified and non-qualified investors, will stay in place. The new classification of article 4 FinSA will not apply to collective investment schemes. However, the definition of qualified investors under CISA will be aligned with the definition of professional clients under the FinSA, including high-net worth individuals who have opted to be treated as professional clients and funds and management companies which choose to be treated as institutional investors. The CISA definition will, however, be broader than the definition of professional clients under the FinSA, since clients of Swiss and foreign regulated financial intermediaries subject to equivalent prudential supervision who entered into long-term investment management or advice agreements will continue to be treated as qualified investors unless they elect not to do so.

Rules of Conduct

The FinSA introduces a comprehensive set of rules of conduct including **information duties**, **appropriateness** and **suitability** requirements as well as documentation and accountability duties. However, the **rules of conduct do not apply to interactions with institutional clients**. Interactions with professional clients will be subject to the rules of conduct, but the clients may waive the requirement to comply with the information, documentation and accountability duties under the FinSA. The draft FinSO states that such a **waiver must be in writing** (or in another form, which allows the proof of waiver by text) and has to remain separate from the general terms and conditions.

Information Duties

Before entering into an agreement or providing services to a client, financial service providers must provide their clients with **key information** such as their name and address, the scope of activities and status of supervision, the procedures for initiating a conciliation procedure before an ombudsman, and general information regarding risks with financial instruments.

Moreover, financial service providers must inform their clients **about the financial services they recommend to the client personally** (incl. risks and costs), their existing economic ties with third parties connected with the financial service offered (incl. acceptance of commission, inducements or other benefits), and the market offerings considered for the selection of the financial instruments. The draft FinSO provides more detailed information on the type of information that needs to be provided. One notable point is that connections to other group entities will require express disclosure, as if they were third parties.

Finally, if a financial service provider personally recommends a financial instrument to a retail client, it will have to **make a key information document and/or prospectus** available if such a document is/are required under the FinSA. Furthermore, a financial service provider will also be required to provide a key information document to execution-only clients, if the key information document is available.

The information set out above must be comprehensible and may be satisfied in a **standardized form** and **delivered in hard copy or electronically**. These duties are further specified in the draft FinSO, which also clarifies the circumstances under which a client may waive its right to obtain a key information document.

Suitability and Appropriateness Duties

Financial service providers who provide **investment advice** or **portfolio management services** are required to verify beforehand whether a specific service or instrument is suitable or appropriate for a particular client.

The extent of the verification will depend on the type of financial services offered:

– **Investment advice for isolated transactions, without considering the entire portfolio**: The financial service provider must 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 service or make an investment in such products, without considering its financial situation and investment objectives (**appropriateness test**).

– **Investment advice considering the whole portfolio of the client or asset management**: The financial service provider must ensure it knows each client's financial situation and investment objectives as well as its knowledge and experience. Based on this information, the financial service provider must determine whether the services and instruments it offers are suitable (**suitability test**).

The distinction between transaction and portfolio-based advice is not found in MiFID II, which requires a suitability review in all cases where investment advice is provided.

– **Execution-only**: Execution only services are exempt from the suitability and appropriateness duties, even if such services are provided to a client who has entered into an investment advice or portfolio management agreement. Before rendering any such service, financial service providers must inform their clients accordingly. This is a discrepancy with regard to the respective MiFID II provision. Under MiFID II, a financial service provider must generally take steps to ensure the appropriateness of the investment for execution-only transactions.

The draft FinSO provides that if a natural person acts through an authorized representative, the financial service provider must consider the representative's knowledge and experience in order to verify whether a specific service or instrument is suitable or appropriate. This rule will allow banks to assess the appropriateness or suitability of investments for clients acting through an external portfolio manager based on the experience of the latter.

If a provider is not able to assess the suitability or appropriateness due to a lack of information provided by the client, that financial service provider is not barred from providing the services, but must inform the client that it was unable to verify the suitability or appropriateness for that client. Similarly, a financial service provider is not barred from providing services which it considers are not suitable or appropriate, but must inform the client of its determination and advise against such services.

The suitability and appropriateness requirements apply not only to relations with retail clients, but also to relations with professional clients. However, financial service providers may assume that professional clients have sufficient knowledge and experience as well as the capacity to bear the risks, so reducing the burden of the appropriateness and suitability requirements.

Transparency and Diligence

Financial service providers are required to handle client orders in **good faith** and in line with the **principle of equal treatment**.

In particular, client orders have to be conducted in the best interests of the client (**best execution**). The financial service provider must ensure that the client obtains the best possible result in terms of costs, speed and quality, considering both financial and non-financial criteria. The financial service provider will have to issue **internal directives** regarding the execution of client orders.

The general duty to act in good faith also comes into play in connection with the use of financial instruments in client portfolios. The FinSA allows financial service providers to engage in **securities lending with client assets** only: (1) if the client expressly empowers them to do so in a written document (or in another manner verifiable by text) that is separate from the general terms and conditions, and (2) on a fully collateralized basis. Uncovered transactions with financial instruments of retail clients are not permitted at all.

Documentation and Accountability Duties

To facilitate the enforcement of the rules of conduct, the FinSA backs the rules of conduct with an **extensive documentation duty**. Financial service providers are required to document their services in an appropriate manner. Among others, they must document the financial services agreed with the client and the information collected about the client, any information and warnings they gave their clients under the suitability and appropriateness rules, as well as the services that were actually provided. Moreover, providers of investment advice will need to keep records of their clients' needs and the underlying reason for each buy or sale recommendation.

Clients may **request copies** of these records. The financial service provider must comply with the relevant request within 30 days; if it fails to comply with such a request, the client may then apply to the court. Furthermore, service providers are required to account to their clients upon request for transactions carried out on their behalf, on the composition, valuation and development of their portfolio, as well as on the costs and expenses associated with the services. Such requests must be serviced according to the draft FinSO within three business days.

Other Organizational Obligations

In addition to the 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 under the FinSA. The supervisory obligations to select, instruct and supervise the involved third party have no direct impact on the question of civil liability of a financial service provider for acts of the instructed third party.

Within a **chain of service providers**, the **instructing financial service provider** remains **responsible for ensuring that the financial service provider it retains comply with the rules of conduct**. On the other hand, further 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.

To the extent that this obligation applies in the event of a delegation, these obligations do not apply to interactions between financial service providers that are retained directly by the client. Therefore, the interactions between a bank and an external asset manager should not be subject to this provision.

The FinSA also covers **conflicts of interest**. The draft FinSO clarifies the term and illustrates by way of examples the cases where conflicts of interest may generally exist. For instance, a conflict of interest exists if the financial service provider has an interest in the outcome of the service provided to the client that is contrary to the interest of the client. Moreover, the draft FinSO also lists activities that are always subject to a conflict of interest and consequently, inadmissible. Such inadmissible activities are churning, front, parallel and after running, as well as price fraud.

The FinSA also covers **conflicts of interest arising out of distribution fees, trailer fees or any other types of retrocessions** by codifying the case-law of the Swiss Federal Supreme Court. Financial service providers may accept **compensation from third parties**, including other group entities, only if: (1) they have expressly informed the clients of such compensation in advance and clients have waived such compensation; or (2) they pass on the compensation to the clients in full. The information must explain the nature and scope of the compensation, and must be given to the clients before conducting financial services or any conclusion of the contract. In the case of an indeterminable amount of compensation, the financial service provider must disclose the calculation parameters and ranges and, upon request, the effective amounts received. Even in cases where the client waives its rights, the financial service provider must provide the client with the above-mentioned information.

Financial service providers must take appropriate organizational measures to prevent conflicts of interest that could arise through the provision of financial services or any disadvantages for clients as a result of conflicts of interest. In particular, the draft FinSO provides that financial service providers must adopt the following measures:

– measures to identify conflicts of interest;

– prevent the exchange of information to the extent that it might conflict with the interests of the client or monitor the exchange appropriately;

– separate the organization and management of employees, if their main function could cause a conflict of interest between clients or between the interests of clients and those of the financial service provider;

– establish processes necessary to prevent employees involved in different financial services at the same time or immediately following each other from being assigned tasks that could interfere with the proper management of conflict of interests;

– ensure that any compensation policy must avoid having the effect of generating a conflict with the duty of good faith;

– set out internal directives to ensure that conflicts of interest between clients and employees are identified and clarify how such conflicts must be resolved; and

– establish detailed rules for the acquisition and disposal of financial instruments by employees for their own account.

If conflicts of interest cannot be eliminated then they must be disclosed to clients. Such disclosure duties may be complied with in a standardized form and electronically.

Liability and Access to Justice

The rules of conduct are **public law**. Non-compliance with the rules of conduct may not only lead to supervisory consequences or, for persons who are not subject to prudential supervision and persons acting on their behalf, but also to administrative criminal sanctions. The supervision and enforcement of the conduct rules will be the task of the supervisory authority (supervisory organization and/or FINMA) in the case of a **supervised financial service provider**. The supervisory authority will monitor on an ongoing basis whether the supervised financial service provider complies with the rules of conduct, and may take enforcement actions in case of non-compliance.

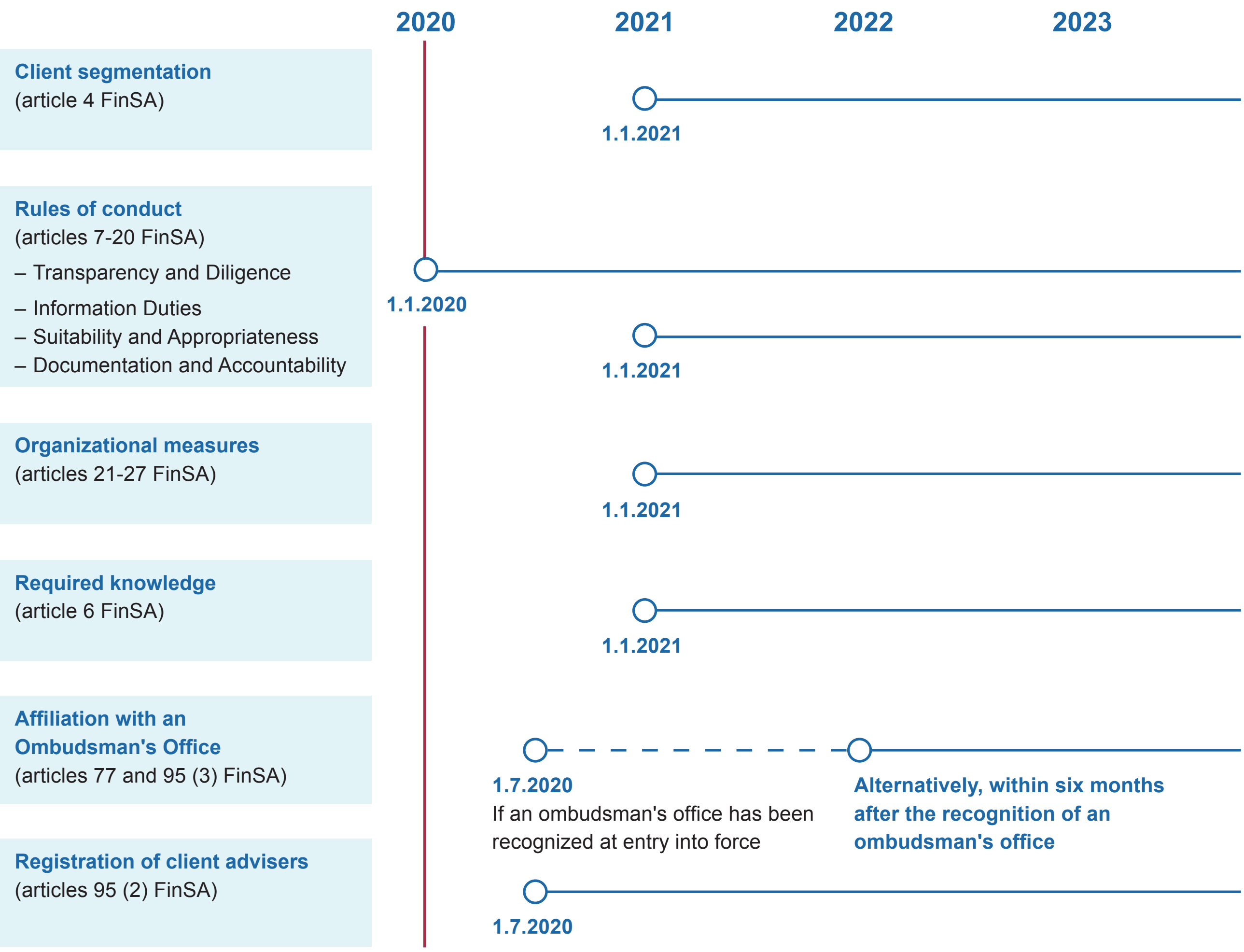
On the other hand, a **non-supervised financial service provider** will be subject to criminal sanctions according to the FinSA. The FinSA foresees criminal sanctions by way of fines of up to CHF 100,000 for intentional violations of the rules of conduct.

In contrast, the FinSA does not supersede private law. A civil judge will continue to decide a civil law dispute solely on the basis of private law. However, the FinSA may come into play when interpreting and applying private and thus spill over (*Ausstrahlungswirkung*) into the civil law relationship.

Finally, financial service providers will be required to join an ombudsman's office, which will offer a simple and informal process to settle disputes between clients and financial service providers.

Outlook: Entry in Force and Transitional Period

It is currently expected that the FinSA, together with its implementing ordinance, will enter into force on 1 January 2020. The FinSA will apply from the first day. However, according to the draft FinSO the following transitional provisions will apply:



- Financial service providers must comply with the obligation to segment clients **within one year** of the entry into force of the FinSO.

- Client advisers must meet the requirements stated in article 7 FinSA **within one year** of the entry into force of the FinSO.

- Financial service providers must comply with the information duty, the suitability and appropriateness duty, and the documentation and accountability duty **within one year** after the entry into force of the FinSO.

- Financial service providers must comply with the organizational measures as set out in articles 21-27 FinSA **within one year** of the entry into force of the FinSO.

- Financial service providers must affiliate to an ombudsman's office **within six months** from the entry into force if such ombudsman's office already exists, or within six months after the recognition of such by the Federal Department of Finance.

Therefore, financial service providers will need to ensure that they classify their Swiss clients and implement the necessary organizational requirements and internal guidelines to comply with their obligations under the FinSA, and, as the case may be, revise their contractual agreements with their clients in a timely manner.

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