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BANKING & FINANCE

New Rules of Conduct for Financial Services Providers

As of January 2020, the Federal Act on Financial Services (FinSA) will introduce new rules of conduct at the point of sale for financial services providers, aimed at aligning the Swiss financial market legislation with MiFID II. Their impact depends on the client category and whether the service qualifies as portfolio management, advisory or execution only client relationship. The consultation on the draft ordinance to the FinSA (Draft-FinSO) ends on 6 February 2019.

1 INTRODUCTION

As regards matters regulated by the Swiss Financial Market Infrastructure Act (**FMIA**), Swiss law is already in line with EU law (e.g. with respect to the regulation of **financial market infrastructures** and **derivatives markets**). One of the aims of the new FinSA and the Federal Act on Financial Institutions (**FinIA**) is to align the Swiss financial market legislation with **MiFID II**. This should allow EU authorities to grant the "**equivalence status**" to Switzerland under the MiFID II market access rules for financial services providers from third country jurisdictions.

The **new conduct rules** for financial services providers under FinSA include (i) a new **client segmentation** as private clients, professional clients and institutional clients instead of the previous classification as qualified and non-qualified investors, (ii) rules on **pre-trade disclosure** in addition to standardised risk disclosure as currently in place, (iii) **suitability** and **appropriateness** checks for portfolio management and advisory clients, (iv) an update of the rules on **best execution, conflicts of interest and equal treatment** of investors, (v) a codification of the Swiss case-law on the receipt of **inducements** and (vi) the introduction of a requirement to **register front office staff**.

The new FinSA rules of conduct will apply to **financial services providers**, i.e. entities or persons providing financial services in relation to financial instruments in Switzerland or to clients in Switzerland on a professional basis. Insurance companies and pension funds will be exempted from their scope. What constitutes **financial services** in the sense of the FinSA is aligned with the MiFID II definitions and includes the following activities:

> **buying** or **selling** financial instruments;

> receipt and transmission of **orders** relating to financial instruments;

> **portfolio management** activities relating to financial instruments;

> **investment advisory** services provided in relation to financial instruments; and

> providing **financing** in relation to transactions with financial instruments.

While many Swiss financial services providers are subject to prudential supervision by FINMA, this is not a requirement to fall into the scope of the FinSA rules of conduct.

Pursuant to FinSA, **financial instruments** are (i) equity instruments qualifying as securities and debt instruments that may be converted into equity instruments, (ii) debt instruments (including bonds and other debt instruments) qualifying as securities, (iii) units in collective investment schemes, (iv) structured products, (v) derivatives in the sense of FMIA and (vi) structured deposits. Other than for (i) and (ii), the scope of the FinSA rules of conduct for financial services providers does **not** depend on the financial instruments qualifying as **securities**.

2 CLIENT SEGMENTATION

2.1 CLIENT CATEGORIES

Financial services providers will have to classify their clients as **private clients**, **professional clients** or **institutional clients**, unless all clients are treated as private clients.

Institutional clients are financial services providers subject to prudential supervision in Switzerland or abroad (banks, securities firms, fund management companies and licensed asset managers and trustees), insurance companies, central banks and certain public law entities with professional treasury functions.

The category of **professional clients** includes, in addition to institutional clients, pension funds, public law entities and corporate entities with professional treasury operations, large undertakings (defined as crossing two of the following thresholds: balance sheet of CHF 20m, turnover of CHF 40m and equity capital of CHF 2m) and private investment structures with professional treasury functions for private clients entitled to opt-out of their status.

Clients are **private clients** by default if they are not institutional clients or professional clients.

In addition, for the purposes of investing in **collective investment schemes**, a further classification of clients as qualified and non-qualified investors remains relevant in order to determine the regulatory requirements.

2.2 OPTING-OUT BY PRIVATE CLIENTS

Private clients may **opt-out** from their status into the status of a professional client if they have either (i) invested assets of at least CHF 500,000 and, due to their education and professional experience or due to equivalent experience in the financial sector, sufficient know-how to understand the risks of their investments or (ii) invested assets of at least CHF 2m.

Invested assets are, according to the Draft-FinSO, (i) bank credit balances at sight or on demand, (ii) securities including collective investment schemes and structured products, (iii) derivatives, (iv) precious metals, (v) life insurance policies with a surrender value and (vi) trust funds. However, any investments in real estate and claims resulting from social security contributions are not included. Note the difference to the current regime, where the opt-out of an individual into the status of a qualified investor is possible with invested assets of at least CHF 5m, counting also real estate up to CHF 2m.

Private clients holding assets jointly must opt-out **jointly**.

If a private client acts through an **asset manager**, he may declare in writing that the knowledge and experience of such asset manager should be taken into account. However, as opposed to the classification as a qualified investor under the current regime, a portfolio management contract with a qualifying asset manager does not lead to a default classification as a professional client.

2.3 OPTING-IN BY PROFESSIONAL AND INSTITUTIONAL CLIENTS

Conversely, **professional clients** may **opt into** the status of a private client. Similarly, **institutional clients** may declare to be treated as professional clients. A financial services provider must inform its professional and institutional clients about their opt-in possibilities.

> "Clients are private clients by default if they are not institutional clients or professional clients."

3 DETERMINATION OF SERVICE TYPE

To determine the scope of its point of sale obligations, the financial services provider must **classify** its client-relationships into the categories of (i) **portfolio management contracts**, (ii) **advisory contracts**, and (iii) **execution only relationships**, which are by default those without a portfolio management or advisory contract.

4 NEW RULES OF CONDUCT AT POINT OF SALE

4.1 PERSONAL SCOPE

While the new rules of conduct do not apply to institutional clients, they will fully apply to private clients. Professional clients may waive the rights discussed under 4.2 and 4.4 below.

4.2 PROVIDING PRE-TRADE INFORMATION

As regards **pre-trade information**, a financial services provider will have to inform its clients about (i) its name and address, (ii) its fields of activity, (iii) its regulatory status, (iv) the possibility to initiate a mediation process before a recognized ombudsman service and (v) the risks linked to financial instruments generally. Such information can be provided in a **standardized brochure** in a similar way as the risk disclosure brochure regarding risks in securities trading published by the Swiss Bankers Association that was made available to clients as part of the client onboarding so far.

In addition, the pre-trade information will also have to include:

- **Disclosure of the costs relating to the financial services**: According to the Draft-FinSO, the financial services provider must disclose the **one-off costs** (e.g. account opening or termination fees) and **recurring costs** (e.g. annual custody or management fees) arising in connection with the financial service. This disclosure must be made when entering into the relevant agreement (e.g. a portfolio management or advisory agreement) or before the relevant financial service is provided for the first time (e.g. entering into transactions). The disclosure must be made as precisely as possible and may be made – to the extent that it is not possible otherwise – on the basis of general tariffs. However, on the basis of FinSA, an obligation to provide a pre-trade disclosure on costs in relation to a transaction only applies if the financial services provider recommends the product, for instance in the context of an investment advisory relationship.

- **Disclosure of risks relating to the financial services**: For investment advisory services, such disclosure must include information about the financial instruments to be purchased, taking into account the client portfolio. For portfolio management contracts, it includes a disclosure of the risks arising from the investment strategy.

- **Disclosure of potential conflicts**: This disclosure must include any involvement of third parties that could give rise to a conflict of interest and any measures to mitigate such risks.

- **Disclosure of the offers taken into account**: This disclosure must include information on whether offers were sourced from third parties.

- **Key information document (KID)**: Where a financial instrument is offered to **private clients**, in line with the obligation arising in the EU under the PRIIPs Regulation, the producer must **prepare a KID**. This obligation does not apply to **equity instruments** (including convertible bonds) and **debt instruments without a derivative character** (e.g. fixed rate bonds, perpetual bonds, plain-vanilla floating rate bonds). To the extent that a KID must be prepared, the financial services provider at the point of sale must make it available to private clients when **recommending** the product. As a result, the KID does not need to be made available by a financial services provider providing execution only services, except where a KID is already available. If a financial instrument is designed to be offered **to portfolio management clients** only, no KID must be prepared.

- **Prospectus**: If a prospectus has been prepared (see our previous Newsletter of January 2019), the financial services provider must make it available upon request.

4.3 SUITABILITY AND APPROPRIATENESS

Financial services providers offering **portfolio management services** must assess the **suitability** of the service for the clients. This is also the case if the service consists of comprehensive **investment advice** provided in relation to a client **portfolio**. Where investment advice is limited to individual transactions, only an **appropriateness** test is required.

As part of such appropriateness test, the financial services provider has to examine the knowhow and experience of his client in order to verify if the recommended financial instrument is appropriate for the client. The suitability test must also take into account the client's financial situation and his or her investment goals.

For clients with **execution-only relationships** – as opposed to MiFID II, where this is only the case for non-complex financial instruments – no suitability or appropriateness test is required. The financial services provider has to inform such clients that no test will be conducted.

> "Pre-trade information will have to include a disclosure of costs."

4.4 DOCUMENTATION AND ACCOUNTABILITY OBLIGATIONS

A financial services provider has to **document** the financial services agreed with the client and any information collected on the client. It must **provide a copy** of the documentation to the client upon request within three working days.

5 BEST EXECUTION

Financial services providers need to ensure that client orders are always executed in the **best possible way** regarding financial terms, timing of execution as well as other terms and conditions. They define in a **best execution policy** to be reviewed annually the criteria necessary for the execution of client orders, including the price, costs, timeliness and probability of execution and settlement.

6 INDUCEMENTS

Inducements include payments or non-monetary benefits a financial services provider receives from third parties in the context of investments into their products by its clients. Under Swiss law, the client is entitled to such payments, unless he or she has validly waived such right. A valid waiver requires that the client at least knows a percentage range applicable to such payment. The possibility of a waiver is not in line with MiFID II, which prohibits an investment firm from accepting and retaining inducements received when providing investment advice on an independent basis.

7 REGISTRATION OF FRONT OFFICE STAFF

Client advisors of financial services providers not supervised by FINMA or a supervisory organisation according to the Financial Market Supervision Act (e.g. Swiss investment advisors or foreign financial services providers without a Swiss presence) will become subject to a requirement to be **registered in Switzerland** under FinSA. The new rules provide for a limited exemption for client advisors of a foreign financial services provider if (i) it is part of a financial group falling under the consolidated supervision of FINMA and (ii) the client advisors transact in Switzerland with professional or institutional clients only. Given the limited scope of the exemption, we expect that the registration requirement will apply to many foreign market participants doing business in Switzerland.

8 OUTLOOK

It remains to be seen whether the alignment of Swiss law with MiFID II under FinSA will be sufficient to obtain the "**equivalence status**" for the third country jurisdiction market access rules of MiFID II. On some key points, Swiss law takes a **more liberal** approach than EU law, e.g. by continuing to allow the **receipt of inducements** if the client has provided a valid waiver, or by omitting to regulate the **unbundling of research** and the way research should be paid for. Also regarding **product governance rules**, Swiss law seems more liberal than the applicable EU regulations.

FinSa is scheduled to enter into force on 1 January 2020. Financial services providers will benefit from a transition period of one year to complete the client segmentation and ensure compliance with the new rules of conduct at the point of sale (as discussed under 2 and 4 above). Client advisors subject to a registration requirement (as discussed under 7 above) will have to file their application for a registration by 1 July 2020.

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The content of this Newsletter does not constitute legal or tax advice and may not be relied upon as such. Should you seek advice with regard to your specific circumstances, please contact your Schellenberg Wittmer liaison or any of the following persons:

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