

FINSA AND FINIA – A PARADIGM SHIFT IN FINANCIAL MARKET LAW

The Federal Act on Financial Services (FinSA) and the Federal Act on Financial Institutions (FinIA) are expected to take effect on 1 January 2020. These two laws will radically transform the current financial market structure. Below is a brief overview of the major changes that FinSA will bring.

I. WHAT DO FINSA AND FINIA AIM TO ACCOMPLISH?

The two acts are intended to strengthen customer protections as well as the reputation and competitiveness of the Swiss financial industry. This set of regulations is also intended to provide Swiss financial institutions with access to the European market. Under FinSA, uniform conditions for the provision of financial services will be created across market sectors. Business conduct at the point of sale for all financial products will eventually be regulated through FinSA. Uniform rules will also apply to the sales documentation of financial products. In the future, FinIA will subject all asset managers to prudential supervision. This represents a significant change for independent asset managers, as they have previously not been subject to a comparable supervisory regime.

Many FinSA provisions are specified in more detail in the Financial Services Ordinance (FinSO). The consultation procedure on the draft FinSO (D-FinSO) ended on 6 February 2019. The regulations in the D-FinSO have therefore not yet been fully finalized. The final versions are expected in the 3rd quarter of 2019.

II. WHO IS SUBJECT TO FINSA?

FinSA applies to financial service providers, client advisors as well as to producers and providers of financial instruments.

Financial service providers are persons who provide financial services on a commercial basis in Switzerland, or for clients in Switzerland. The definition of financial services is crucial to the applicability of FinSA. The following activities performed on behalf of clients are considered financial services under FinSA:

- purchase or sale of financial instruments;
- acceptance and transmission of orders relating to financial instruments;
- asset management;
- investment advice; and
- granting of loans for the execution of transactions with financial instruments.

The distribution of investment funds is also considered a financial service.

Financial instruments according to FinSA include equity securities such as shares, participation or dividend-right certificates, bonds, shares in collective investment schemes, structured products and derivatives.

Client advisors are natural persons who provide financial services on behalf of a financial service provider or as act as financial service providers themselves.

However, FinSA does not cover insurance companies and insurance brokers whose activities are subject to the Insurance Supervision Act, nor does it cover pension funds.

III. CLIENT SEGMENTATION AS A NEW OBLIGATION FOR FINANCIAL SERVICE PROVIDERS AT THE POINT OF SALE

Financial service providers must assign clients, who they are assisting with financial services, to one of the following segments:

- Institutional Clients;
- Professional Clients;
- Retail Clients.

The applicability of FinSA customer protection provisions varies according to client segment.

Institutional Clients include:

- financial intermediaries pursuant to the Banking Act, FinIA and the Federal Act on Collective Investment Schemes (CISA), such as banks, fund management companies, asset managers and securities firms;
- insurance companies under the Insurance Supervision Act;
- foreign clients subject to prudential supervision, such as foreign banks, fund management companies and asset managers;
- central banks; and
- national and supranational public corporations with professional treasury.

In addition to the Institutional Clients mentioned above, the **Professional Clients** segment further includes the following:

- pension funds with professional treasury;
- companies with professional treasury;
- large companies (i.e. companies exceeding two of the following criteria: balance sheet total of CHF 20 million, revenue of CHF 40 million, equity of CHF 2 million); and
- Private investment structures with professional treasury, established for high-net-worth Individuals.

Retail Clients are all clients who are neither Professional nor Institutional Clients. As Retail Clients, they enjoy the full range of customer protections provided by FinSA.

Any financial service provider who treats all clients as Retail Clients can forgo customer segmentation.

IV. OPTING-IN AND OPTING-OUT

Certain client categories offer an **opting-in** choice, which provides a higher level of customer protections. Conversely, certain client categories offer the choice of **opting-out**, which results in a lower level of customer protections.

An opting-in (= higher level of customer protection) can be declared by:

- Institutional Clients stating that they wish to be considered Professional Clients;
- Pension funds, companies with professional treasury, large companies and private investment structures with professional treasury established for retail clients stating that they wish to be regarded as Retail Clients.

An opting-out (= lower level of customer protection) can be declared by:

- Pension funds and companies with professional treasury stating that they want to be regarded as Institutional Clients;
- high-net-worth Individual , stating that they want to be regarded as Professional Clients.

A high-net-worth Individual is a person who, either on the basis of his/her personal education and professional experience, or on the basis of comparable experience in the financial sector, has the necessary knowledge to understand the given investment risks and has assets of at least CHF 500,000, or who has assets of at least CHF 2 million. According to D- FinSO, assets include financial investments that are directly or indirectly owned by Retail Clients, such as sight or time deposits, securities including collective investment schemes, structured products, derivatives, precious metals, life insurance with surrender value and fiduciary investments. Directly held real estate and claims related to social insurance schemes may not be counted as assets.

Retail Clients who are not high-net-worth Individuals as described above cannot opt out. The full range of FinSA customer protections always applies to them.

V. REQUIREMENTS FOR THE PROVISION OF FINANCIAL SERVICES AT THE POINT OF SALE

Anyone providing financial services must comply with the requirements set out in FinSA. Client advisors must have **adequate knowledge** of the rules of conduct as set out below in this section V, i.e. they must know, for example, what obligations to inform they have towards their clients, whether a suitability or appropriateness test needs to be carried out, how they fulfil their documentation and accountability obligations. Client advisors must also have the specialist knowledge required to adequately perform their tasks.

The following **obligations** must accordingly be observed:

Financial service providers have a **duty to inform**. Before concluding a contract or providing a service, they must inform their clients about the recommended financial service and the associated risks and costs, any existing economic ties to third parties in connection with the financial service offered and the market offerings taken into account when selecting the financial instruments.

In the case of asset management and investment advisory services which take the client portfolio into consideration, the financial service provider must carry out a **suitability test**, i.e. the provider must inquire about the financial circumstances and investment objectives as well as knowledge and experience of the clients.

If the investment advice is limited to individual transactions only, without the entire client portfolio being considered, the financial service provider must perform a **appropriateness test** by inquiring about the knowledge and experience of the client and, before recommending financial instruments, assess whether these are appropriate for the client. The appropriateness and suitability tests for execution-only orders - i.e. when client orders are merely executed or transmitted without advising the client beforehand – do not need to be carried out. However, this must be communicated to the client prior to the execution or transmission of the client order.

The appropriateness and suitability tests are further not required for Professional Clients. The financial service providers can assume that they have the necessary knowledge and experience and can financially cope with the investment risks.

FinSA further imposes on financial service providers the **obligation to document** the information collected from clients, the financial services agreed upon and the financial services provided to clients. When providing investment advice, the client's needs and the reasons for a recommendation leading to the purchase of a financial instrument must also be documented. Clients may request a copy of this documentation.

In addition, financial service providers must, upon request by a client, account for the financial services they have provided and agreed to provide, the composition, valuation and development of the client portfolio and the costs associated with the provision of financial services.

Furthermore, financial service providers are subject to the **principles of good faith and equal treatment in the processing of client orders**, which must be executed in the best possible way in terms of financial, timing and quality criteria. D-FinSO specifies these principles in concrete terms by requiring, among other things, that financial service providers have in place appropriate systems and procedures for processing client orders and must ensure that client orders are registered and assigned promptly and correctly, that comparable client orders are generally executed immediately in the order received, and that the interests of the clients involved are safeguarded when orders from different clients or orders from clients with own transactions of the financial service provider are combined.

The rules of conduct set out in this section V shall apply in full to all Retail Clients. They shall apply to Professional Clients unless they have expressly waived the financial service provider's duty to inform, document and be accountable. These rules of conduct do not apply to transactions with Institutional Clients.

FinSA provides for a **fine of CHF 100,000** if, in fulfilling the information obligations, false information is deliberately provided or essential facts are concealed, or if the obligation to carry out an appropriateness and/or suitability test has been seriously and intentionally breached. Banks and other persons supervised under the Financial Market Supervision Act as well as persons working for such institutions are exempt from this penalty. They are subject to the regulatory and criminal sanctions regime of the Financial Market Supervision Act.

VI. AVOIDANCE OF CONFLICTS OF INTEREST AND APPROPRIATE ORGANIZATION FOR FINANCIAL SERVICE PROVIDERS OBLIGATIONS

Financial service providers must take adequate measures to prevent clients from being disadvantaged by conflicts of interest and/or to avoid conflicts of interest that may arise out of the provision of financial services. If disadvantaging of a client cannot be ruled out, the financial service provider must disclose this to the client. D- FinSO outlines three types of conduct, which are prohibited in any case due to conflicts of interest:

- shifting of client portfolios without an economic reason in the client's interest;
- exploiting information to the client's disadvantage; and
- manipulations of services in connection with issues or placements of financial instruments to the detriment of the client.

Retrocessions, i.e. compensation which the financial service provider receives from third parties in connection with the provision of financial services, such as commissions and discounts, remain permissible under FinSA, provided that the clients have been explicitly informed of the type and scope of the compensation or of the underlying calculation parameters (if the amount of the compensation cannot be determined in advance) prior to the provision of the financial service or, respectively, the conclusion of the contract. The financial service provider may retain retrocessions if the client waives his/her claim to them after being duly informed. If the client does not waive this right, the financial service provider must pass on the received retrocessions to the client in full. This regulation corresponds to the applicable law on mandate agreements in Art. 400 Code of Obligations and has been confirmed several times by the Federal Supreme Court.

If however the financial service provider works for a pension fund or a collective investment scheme, retrocessions must be passed through to the pension fund or collective investment scheme.

Deliberate breaches of the provisions on retrocessions may result in a fine of CHF 100,000. Banks and other persons supervised under the Financial Market Supervision Act and persons working for such institutions are exempt from this penalty. They are subject to the supervisory and criminal sanctions regime of the Financial Market Supervision Act.

Financial service providers must ensure compliance with the obligations outlined by FinSA by means of **appropriate organizational structures and internal policies**. The requirements for organizational structures and internal policies depend on the size, complexity and type of legal entity of the respective financial service provider, the financial services offered as well as the corresponding risks. If special statutory regulations apply to financial service providers in this respect, such as the Banking Act for banks, such financial service providers are not additionally subject to the requirements of FinSA and FinSO.

The financial service providers must carefully select their **employees** regarding the specific tasks to be performed, in order to assure that employees possess the **adequate levels of skill, expertise and experience**. This requirement also includes the necessary employee training and further education.

Financial service providers must also put in place measures to prevent employees from misusing confidential information for own-account transactions.

VII. INTRODUCTION OF AN ADVISOR REGISTRY

Client advisors of non-supervised Swiss financial service providers and client advisors of foreign financial service providers may only carry out their activities in Switzerland once duly listed in an advisor registry. This registration obligation applies, for example, to pure investment advisors, i.e. persons who provide investment advice but do not make investment decisions for their clients.

Accordingly, unregulated Swiss financial service providers, e.g. pure investment advisors, may only employ client advisors duly listed in the advisor registry.

According to FinSA, the Federal Council may exempt client advisors of foreign financial service providers subject to prudential supervision from the registration requirement if they provide their services in Switzerland exclusively to Professional or Institutional Clients. The Federal Council may also make such an exception contingent on the foreign state in question granting reciprocal rights. The Federal Council has provided for such an exception in D-FinSO for client advisors of foreign financial service providers who are subject to prudential supervision abroad and who are part of a financial group which is legally subject to the consolidated supervision of FINMA. The Federal Council considers this exception to be justified, as such client advisors are effectively subject to supervision by FINMA through their financial service provider.

The entry in the advisor registry requires proof that

- the client advisor has adequate knowledge of FinSA rules of conduct and the appropriate expertise required to perform his/her job;
- the client advisor him-/herself or the financial services provider he/she works for has professional indemnity insurance coverage or equivalent financial guarantees in place; and
- the client advisor him-/herself or the financial services provider he/she works for is affiliated with an ombudsman service (see section XI below).

Neither FinSA nor D-FinSO specify how the necessary expertise and knowledge of FinSA rules must be demonstrated. The advisor registry should therefore have discretion in determining whether a client advisor fulfils the above registration requirements. When registering, the client advisor must prove that he/she has the necessary knowledge and skills by way of submitting relevant support documents and, if necessary, by completing an interview.

The advisor registry is maintained by a registration body, which must be approved by FINMA.

VIII. UNIFORM PROSPECTUS RULES FOR THE PUBLIC OFFERING AND ADMISSION OF SECURITIES TO TRADING

While current applicable law provides for different regulations with prospectus requirements corresponding to the type of securities to be issued, FinSA establishes uniform regulations with regard to the prospectus.

Going forward, anyone who submits a **public offer to purchase securities** in Switzerland or requests **admission of securities to trading on a stock exchange or multilateral trading system** must first publish a prospectus. Securities are in particular standardized securities, book-entry securities, derivatives and intermediated securities suitable for volume trading.

FinSA defines a **public offer** as any invitation to the public to purchase a financial instrument that contains sufficient information about the terms of the offer and the financial instrument itself. D-FinSO then specifies that the offer is a communication of any kind, usually aimed at drawing attention to a specific financial instrument and selling it. FinSA provides for various **exceptions to the prospectus requirement** according to the type of offer or type securities. For instance, no prospectus is required

- if the public offer is addressed only to Professional Clients or to fewer than 500 investors;
- if the public offer is addressed to investors who acquire securities with a value of at least CHF 100,000, or if it has a denomination per unit of at least CHF 100,000; or
- if the public offer calculated over a period of one year does not exceed a total value of CHF 8 million.

There are also exceptions according to the type of securities, e.g. securities offered or allotted within the framework of a merger, demerger, conversion or transfer of assets. Exceptions are also provided for in connection with admission to trading.

As far as the **content of the prospectus** is concerned, it must contain the information essential for an investor's decision, such as information on the issuer and on the guarantor, on the rights, obligations and risks associated with the securities offered and on the offer (type of placement and estimated net proceeds of the issue). D-FinSO annexes 1-6 specify in detail the minimum information requirements of the prospectus according to the type of securities offered. The prospectus must be drawn up either in an official language of the Swiss Confederation or in English. It must also contain a summary of the most important information to facilitate comparison between similar securities.

FinSA empowers the Federal Council to provide **exemptions from the prospectus requirement**, including for small and medium-sized enterprises and for issuers that regularly offer securities to the public.

Before its publication, the prospectus shall be subject to a **review by an reviewing body** as to its completeness, consistency and comprehensibility. If the reviewing body finds any deficiencies, it shall inform the person submitting the prospectus of this within 10 calendar days of receipt, stating their reasons, and requesting the necessary corrections. The reviewing body shall decide within 10 calendar days of receipt of the corrected prospectus. In the case of new issuers, the period shall be 20 calendar days. If no decision is taken by the reviewing body within these periods, this shall not be deemed approval of the prospectus. The prospectus shall remain valid for 12 months once it has been approved by the reviewing body.

Once approved, the prospectus must be filed with the reviewing body and published, at the latest, when the public offering or admission to trading of the securities concerned commences.

The reviewing bodies require a license from FINMA.

IX. KEY INFORMATION DOCUMENT KID (KID)

If a financial instrument is offered to Retail Clients in Switzerland, a Key Information Document (KID) must be prepared. The KID must be made available to the Retail Client prior to subscription or conclusion of the contract. The KID contains the essential information that allows the investor to make an informed investment decision and to compare between different financial instruments. The contents of the KID in particular include easily understandable information regarding

- the nature and characteristics of the financial instrument;
- the risk and return profile, indicating the maximum loss investors are likely to incur on the capital invested;
- the cost of the financial instrument; and
- the minimum holding period.

D-FinSO Appendix 9 contains a model KID template, including mandatory guidelines on layout and scope of content.

No KID is required

- for financial instruments that may only be acquired for Retail Clients as part of an asset management agreement;
- if securities in the form of shares or securities equivalent to shares are offered, such as participation or dividend certificates and convertible bonds; or
- when debt securities of a non-derivative nature are offered (such as bonds with interest rates based on reference rates or with inflation protection).

Documents that are equivalent to the KID under foreign law may be used in its place.

If a financial instrument for which a KID must be prepared is publicly offered, the KID must be published no later than the start of the public offer.

X. PROSPECTUS AND KID LIABILITY

Any person who makes incorrect, misleading or unlawful statements in the prospectus, the KID or similar notices without exercising the necessary care shall be liable to the purchaser of the financial instrument for the damage caused thereby. Special provisions apply to the summary version in the prospectus and to information on essential assessments.

In addition, FinSA provides for criminal sanctions, including fines of up to CHF 500,000, if false information is deliberately given in the prospectus or in the KID or if crucial facts are concealed or if these documents are not published by the start of the public offering. Anyone who intentionally fails to make the KID available before the subscription, or before the conclusion of the contract respectively, may also be fined up to CHF 100,000. Banks and other persons supervised under the Financial Market Supervision Act and persons working for such institutions are exempt from this penalty. They are subject to the supervisory and criminal sanctions regime of the Financial Market Supervision Act.

XI. OMBUDSMAN AS AN UNBUREAUCRATIC MEANS OF DISPUTE RESOLUTION

Disputes concerning legal claims between the client and the financial service provider should, to the farthest extent possible, be settled by mediation through the ombudsman with whom the client's financial service provider is affiliated. The ombudsman proceedings are confidential, must be inexpensive or free of charge to the client and should be quick, fair, unbureaucratic and impartial. If no agreement can be reached or if there is no prospect of such an agreement being reached, the ombudsman can provide an assessment of the dispute to the parties involved. However, the ombudsman has no decision-making authority.

There is no obligation for the parties to first go through mediation with the ombudsman before they can appeal to a civil court, arbitral tribunal or an administrative authority. Legal action can also be taken during a mediation procedure. In this case, the ombudsman will terminate the mediation proceedings. If the client has submitted a mediation request to the ombudsman, the financial service provider is obliged to participate in the procedure. The reverse however does not apply to the client.

Financial service providers must inform their clients about the option of mediation by the ombudsman, as part of their duty to provide information.

The ombudsman must be recognized by the Federal Department of Finance.

XII. TRANSITIONAL PROVISIONS

FinSA is generally applicable from the first day of its entry into force. Client advisors must apply for entry in the advisor registry within 6 months of the FinSA effective date. Financial service providers must join an ombudsman within six months of the effective date.

In cases of securities for which an offer to the public was made or for which admission to trading on a trading venue was requested before the FinSA effective date, the provisions governing the prospectus and KID shall come into force two years after the FinSA effective date. Similarly, in cases of financial instruments offered to Retail Clients before the FinSA effective date, these provisions shall not apply until two years after the effective date.

D-FinSO further provides for a grace period of one year, from the FinSO effective date, for a number of FinSA obligations such as client segmentation, meeting of client adviser qualification requirements, duty to inform, appropriateness and suitability testing, documentation and accountability requirements and the establishment of appropriate organizational policies and structures.

COMMENTARY

It is a welcome development for FinSA to regulate point of sale conduct for all financial instruments and to introduce uniform regulations regarding product documentation - prospectus and KID. Compliance with this new legislation is likely to increase financial service providers' administrative workload and costs, and thereby impact products and services pricing. It remains to be seen whether FinSA is truly compatible with and considered equivalent with European law, and, given the more liberal FinSA provisions as compared with EU law, whether it will give Swiss financial institutions access to the European market.



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