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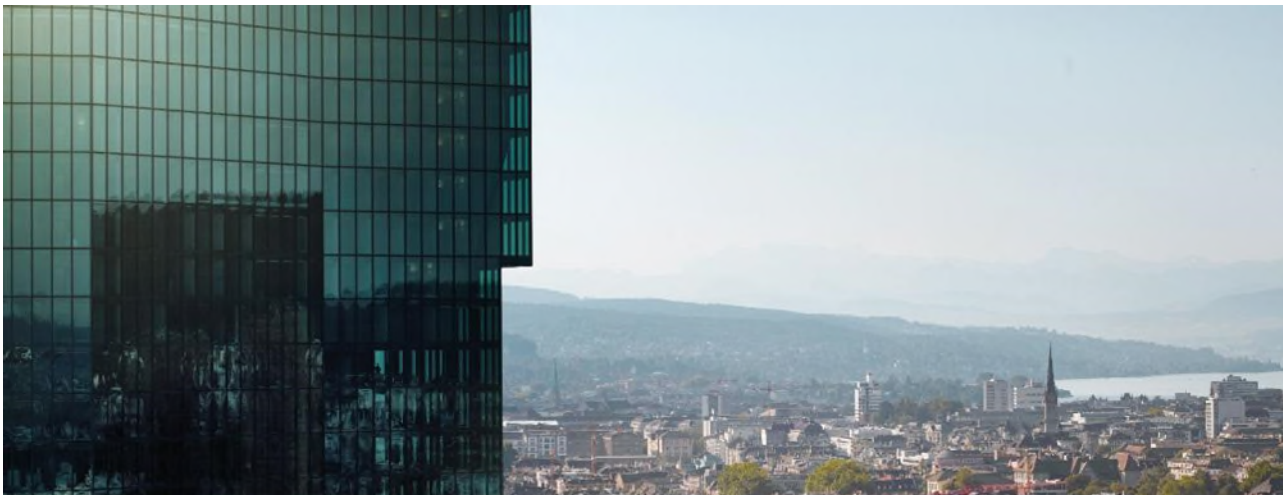

Cross-border Financial Services into Switzerland – New Rules of Conduct

How are foreign financial service providers affected by the new Swiss suitability and appropriateness test? This is the third of a series of bulletins discussing the new regulatory framework for the provision of financial services into Switzerland.

As part of the Financial Services Act of June 15, 2018 (FinSA) new rules of conduct for financial service providers are expected to be introduced on January 1, 2020, subject to applicable phase-in periods. Key elements of these new duties are the suitability and appropriateness test.

The provision of cross-border financial services into Switzerland generally falls within the scope of application of the FinSA. Hence, foreign financial service providers serving Swiss-based clients will also have to comply with these new requirements.

This bulletin outlines the scope of applicability of the suitability and appropriateness test as well as their consequences on the services offered.

I. Introduction

As set forth in our Bulletin of June 28, 2019, the Financial Services Act (**FinSA**) aims to enhance the protection of investors by introducing a number of new conduct rules for financial service providers. In particular, a suitability and appropriateness test will need to be conducted under certain circumstances. To date, no such suitability and appropriateness duties have been prescribed by Swiss financial market regulations. While the new rules are mainly based on MiFID II, there are also certain differences.

II. Scope of Application

Generally, the rules of conduct under the FinSA are only triggered if financial services are rendered to Swiss-based clients, as further outlined in our Bulletin of June 28, 2019. Moreover, as under MiFID II, whether a suitability or appropriateness test needs to be performed depends on (1) the specific financial service offered and (2) the classification of the respective client.

Financial Services

Under the FinSA, financial service providers must conduct a suitability or appropriateness test only if they provide portfolio management or investment advisory services – not for any other financial services (see our Bulletin of June 28, 2019 for an overview of the various financial services covered by the FinSA). In particular, unlike under MiFID II, no appropriateness test is required for mere execution-only transactions. Rather, in this case, the customer just has to be informed that no such test will be carried out. In general, the FinSA has taken a relatively liberal stance towards execution-only transactions with financial instruments. In particular, it does not provide for a general ban on the sale of certain products to retail investors.

In the case of portfolio management services, the financial service provider must assess the suitability of the investment strategy and any transactions executed for the client. Here, it is not yet clear whether the latter also includes specific transaction orders received from clients.

Again unlike MiFID II, the FinSA distinguishes between two types of investment advisory services, each of them requiring a different test: Only if the financial service provider provides investment advice by taking into account the client's entire portfolio (**Portfolio-Related Investment Advice**), it must carry out a suitability test. If it advises the client on individual transactions without taking into account his|her entire portfolio (**Transaction-Related Investment Advice**), it must merely ensure that such recommendation is appropriate. It is unclear, however, whether an investment advice shall be qualified as Portfolio- or Transaction-Related Investment Advice if the financial service provider considers only a part of the client's portfolio. While the wording of the FinSA seems to also qualify such advice as Portfolio-Related Investment Advice, the dispatch on the draft FinSA has classified it as Transaction-Related Investment Advice. Furthermore, financial service providers will need to establish policies allowing them to distinguish between execution-only transactions (that do not require an appropriateness test to be performed) and Transaction-Related Investment Advice, for example in situations where investment related information or topics are shared or discussed with a client.

Client Classification

The applicability of the duties regarding suitability and appropriateness also depends on the client classification. In general, the FinSA distinguishes between retail, professional and institutional clients. As the requirements for a classification as a professional or institutional client under the FinSA tend to be less restrictive than those under MiFID II, a foreign financial service provider classifying its clients in accordance with MiFID II should, presumably, also be compliant with the FinSA. Conversely, EEA-based investment firms may for MiFID II purposes not want to solely rely on client classification under the FinSA, particularly in case of an opting-out of retail clients who have assets of at least CHF 2 million and may therefore opt to be treated as professional clients, if such reclassification is not available under the relevant home country regulation. Also, unlike under MiFID II, a client will need to be classified with respect to the relevant client relationship as such, and not with respect to certain products only.

If the customer is an institutional client, no suitability or appropriateness test is required. While there is no such general exemption for retail or professional clients, financial service providers may assume that professional clients have (1) sufficient knowledge and experience as well as (2) the financial capacity to bear the risks when assessing suitability and appropriateness. As a consequence, when providing financial services to professional clients, generally no appropriateness test is required and the suitability test is limited to the client's investment objectives. However, it should be noted that neither the FinSA nor the draft Financial Services Ordinance (**FinSO**) specify under which circumstances financial service providers are prevented from relying on this assumption. In case of doubt they are therefore well advised to nevertheless inquire (and document) the client's knowledge, experience and financial situation.

III. Content of the Tests

Suitability Test

As part of a suitability test, financial service providers must inquire about the clients' investment objectives and financial situation as well as their knowledge and experience in relation to the relevant financial service. Although the wording of the FinSA is quite clear, certain scholars hold that a financial service provider giving Portfolio-Related Investment Advice must also obtain information on the client's knowledge and experience in relation to each individual transaction recommended – a view which we do, however not share in light of the clear wording of the relevant provisions. Also, there is currently no clear guidance under which circumstances a verification of the information received from the client is required. In our reading of the law, a financial service provider is, in any case, not obliged to take into account indications that may arise from any services rendered to the client other than the specific financial service it provides to the respective client. In our view, universal banks will, in particular, not be required to consider information they may receive from their lending or deposit business.

When providing portfolio management services and Portfolio-Related Investment Advice, banks and other financial service providers shall establish a risk profile for the client based on the information received and, for portfolio management and ongoing advisory services, agree with him|her on an investment strategy. In addition, they shall assess whether the investment strategy and any transactions that they intend to execute are suitable for the client. Pursuant to the dispatch on the draft FinSA, such suitability test shall be carried out regularly during the portfolio management relationship.

In case the financial service provider renders investment advisory services, it shall assess whether the financial instruments that it intends to recommend are suitable for the client. Unlike a portfolio manager, an investment advisor must continuously monitor the suitability of the recommended financial instruments only if it has so undertaken to its client.

Appropriateness Test

The duty to carry out an appropriateness test requires the financial service provider to obtain information on the clients' knowledge and experience. Based on this information, the financial service provider shall assess whether the financial instruments that it intends to recommend are appropriate for the client.

In contrast to the suitability test, neither the FinSA nor the draft FinSO specify whether the relevant information on knowledge and experience must relate to the financial service, the type of the financial instruments or the specific financial instruments. In line with the existing information duties under the current rules of the Stock Exchange and Securities Trading Act and the Collective Investment Schemes Act, we believe that the financial service provider must obtain information on the client's knowledge and experience in relation to the type of the financial instruments that are the subject of the specific investment advice.

As per the wording of the FinSA, financial service providers do not need to inquire into the client's needs in the course of an appropriateness test. It is therefore unclear, why the FinSA elsewhere requires that financial service providers must document the client's needs when providing investment advice. In our view, this documentation obligation should be limited to the specific information that needs to be collected in cases of Portfolio-Related Investment Advice.

Duties in case of Negative Suitability or Appropriateness Test

If the financial service provider finds the financial service or the financial instruments unsuitable or inappropriate for the client, it shall advise against them.

Under the FinSA, financial service providers must document the fact that they advised against the financial service or the financial instrument. Currently, it is not clear if and to what extent this documentation (or the lack thereof) will impact the liability of a financial service provider. While we believe that the a failure of the financial service provider to comply with its documentation obligations should, in general, not have any legal implications on a civil law case, it cannot be excluded that such documentation may lead to a factual reversal of the burden of proof.

IV. Other Rules of Conduct

In addition to the suitability and appropriateness test, financial service providers must also comply with the other regulatory requirements of the FinSA. In particular, the FinSA imposes duties regarding the documentation of certain information in connection with the financial services rendered and the reporting of such information to clients as well as regarding the use of financial instruments from clients' portfolios.

V. Sanctions in case of Non-Compliance

Serious violations of the duty to carry out a suitability or appropriateness test may be sanctioned with a fine of up to CHF 100,000. By imposing criminal sanctions, violations of these provisions may be enforced against foreign financial service providers even in the absence of regulatory consequences.

VI. Need for Action

According to the current draft FinSO, some rules of conduct will need to be complied with as from January 1, 2020. But the expectation is that the final FinSO will provide for a one year phase-in period for almost all conduct rules.

Even though the FinSA aims to align Swiss law with the requirements set forth by MiFID II, certain differences exist between the two regulatory frameworks. As a consequence, foreign financial service providers domiciled in the EU and providing financial services on a cross-border basis into Switzerland may not assume that compliance with the relevant rules under MiFID II is fully sufficient.

Foreign financial service providers should therefore assess which services they provide to which client groups in Switzerland. As a next step, EEA-based investment firms are well advised to carefully review whether their internal processes and contracts with clients are compliant with the requirements on suitability and appropriateness as well as the other duties under the FinSA. Foreign financial service providers domiciled outside of the EEA, on the other hand, should analyze whether in their home jurisdiction they are subject to rules of conduct and client classification requirements that are equivalent to the European standards and whether any other measures to establish compliance with the FinSA are required.

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