New FINMA Circular "Rules of Conduct Under FinSA/FinSO"

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Key takeaways

- **On 15 May 2024, FINMA published the draft of its new circular "Rules of Conduct Under FinSA/FinSO" and launched a public consultation.**
- **The circular is based on FINMA's experience in implementing the conduct obligations pursuant to FinSA and FinSO.**
- **It includes a number of clarifications regarding the way in which financial service providers shall enhance transparency for the benefit of their clients.**
- **In particular, the draft circular contains provisions to increase transparency regarding the type of financial service provided, the risks associated with financial instruments or services, the handling of conflicts of interest, and the disclosure of retrocessions.**

Introduction

On May 15, 2024, FINMA published its draft of a new circular on conduct obligations under FinSA and FinSO and launched a public consultation on this draft circular.
The circular reflects FINMA's experience to date regarding implementing the conduct obligations under FinSA and FinSO by financial service providers that are supervised by either FINMA or a supervisory organisation. In particular, the circular aims both to enhance transparency regarding FINMA's supervisory practice and to establish a uniform level of investor protection amongst financial service providers.

In terms of content, the circular intends to clarify the way in which financial service providers create transparency for the benefit of their clients with regard to the following aspects:

- transparency regarding the type of financial service provided;

- transparency regarding the risks associated with financial instruments or services;
- transparency regarding conflicts of interest; and
- transparency regarding third-party compensation and retrocessions.

Transparency Regarding the Type of Financial Service Provided

As regards the information on financial services that financial service providers provide, the circular especially aims to clarify the distinction between the two types of investment advice under FinSA.

FinSA differentiates between "investment advice for individual transactions" pursuant to art. 11 FinSA (often referred to as "transaction-related advice") on one hand and "investment advice taking account of the client portfolio" pursuant to art. 12 FinSA (often referred to as "portfolio-related advice").

This distinction results in less far-reaching rules of conduct for transaction-related advice compared to portfolio-related advice. In the latter case, financial service providers must carry out an assessment of suitability – as is the case when providing portfolio management services – meaning that the financial service provider must enquire into whether a financial instrument is suitable for clients based on their specific knowledge of investment risks and experience in the financial sector, their financial situation, and their investment objectives. In the former case, however, the financial service provider merely must assess appropriateness, i.e. he must look into whether clients comprehend the recommended financial instrument based on their knowledge and experience.

In this regard, FINMA has found in its supervisory practice, that financial service providers sometimes do not adequately distinguish between the two forms of investment advice and that they provide insufficient information about the nature of the service provided. As a result, clients would sometimes wrongly assume that the financial service provider is providing them with portfolio-related advice and thus has carried out a suitability assessment for investment recommendations. Similarly, financial service providers face a risk that advisory services are wrongly classified as transaction-related advice and thus, in the absence of a suitability assessment, the conduct obligations under FinSA would be systematically breached.

The circular intends to remedy this conflicting situation and requires financial service providers to inform their clients explicitly (i.e. in writing or in another form demonstrable via text) before or upon conclusion of the mandate, or the during the process of providing the financial service, on whether the advisory service offered is portfolio-related or transaction-related. In the latter case, the financial service provider must also inform the client that the advice provided is purely instrument-based, i.e. that the client portfolio is not being considered at all and that only an appropriateness assessment, and no suitability assessment, is carried out.

Transparency Regarding the Risks Associated with Financial Instruments or Services

Information on the Risks Associated with Financial Instruments

FINMA's supervisory activities show that risk disclosure is often inadequate for financial products that are not only difficult for private clients to understand but also involve high risk, such as contracts for difference (CFDs) or rolling spot forex transactions (FX rolling spots), particularly with regard to their leverage effect and potential margin calls for the client.

With regard to such CFDs, the new circular stipulates – by specifying the duty to provide information under FinSA – that the financial service provider must inform its clients of the following:

- the current proportion of clients losing money with the financial service provider as a result of such CFDs as well as the proportion of customers subject to margin calls;
- the existence of any margin calls and the risk of potentially unlimited losses; and
- the leverage effect, functioning of the margin, counterparty risk, and market risk – including slippage (i.e. price changes between placing and executing an order).

Such clarification leads to a harmonisation regarding the duty to provide information on contracts for differences with EU law. It should be emphasised, however, that the significantly further-reaching restrictions of EU law regarding the sale of CFDs to private clients (in particular, initial margin protection, margin closeout protection, and negative balance protection) remain outside of the Swiss framework.

Information on the Risks Associated with the Financial Service

FINMA also notes that the measures for avoiding risk concentrations vary widely amongst financial service providers.

The circular addresses this situation by requiring financial service providers who engage in asset management and portfolio-related investment advice to draw their clients' attention to the nature and extent of risk concentration, if such risk concentration is not customary in the market.

As to the question of which risk concentration is no longer customary in the market, the circular sets out the following guidelines:

- concentrations of 10% or more for individual securities; and/or
- concentrations of 20% or more for individual issuers.

These percentages are indicative values, for which a corresponding risk disclosure is deemed appropriate; they are not, however, fixed thresholds that, if reached or exceeded, trigger an

obligation on the financial service provider to provide information to their clients in any case. Moreover, risk concentrations arising from collective investment schemes subject to regulatory risk diversification rules are excluded from this duty to provide information.

Transparency Regarding Conflicts of Interest

If financial service providers also consider their own financial instruments for their investment solutions, there is an inherent risk that the financial service provider would not select the most advantageous product for the client, but the one with the highest additional remuneration for the financial service provider. This can therefore result in conflicts of interest.

The circular addresses this problem by reiterating the existing cascade of the FinSA for avoiding conflicts of interest and by specifying the requirements for disclosing any conflicts of interest.

If a financial service provider offers investment solutions exclusively comprised of its own products, it must draw its clients' attention to this fact and inform them of potential conflicts of interest and associated risks. If the financial service provider informs its clients that third-party products are being considered, the financial service provider must ensure that it is not guided by its own interests, and to the detriment of its clients' interests, when selecting financial instruments. In particular, the process for the selection of financial products must be based on objective criteria that are customary in the industry (e.g. performance expectations, conformity with the risk profile, desired diversification, costs, etc.).

Transparency Regarding Third-party Compensation and Retrocessions

According to FINMA, most financial service providers – despite a recent downward trend – continue to receive compensation from third parties (so-called retrocessions). At the same time, clients' advance waivers of these retrocessions are usually found in the small print as a pro forma waiver. Furthermore, some financial institutions only provide their clients with information on effectively retained retrocessions for a fee.

The circular stipulates that information on retrocessions in standardised contracts must be highlighted visually (e.g. in bold print or in colour) and must either be handed out to customers physically or made available electronically via a direct link.

If the actual amount of the retrocession cannot be determined before the financial service is provided or before the contract is concluded, the financial service provider must provide information on the calculation parameters and the range of expected retrocessions – this applies to all financial services, in particular, also to transaction-based advice and execution-only relationships. In the case of portfolio management and portfolio-based advice, the financial service provider must also provide information on the range of compensation, based on the portfolio value and the agreed upon investment strategy.

Ultimately, financial service providers must disclose to their clients any retrocessions they have actually received upon the client's request free of charge. Only in exceptional cases, and in the event of extraordinary endeavours, notably if such right to information is exercised repeatedly within a short period of time, the financial service provider may charge its client a

moderate and at most cost-covering flat fee for providing such information.

Next Steps

FINMA's public consultation on the draft circular will continue for two months and will end on 15 July 2024, after which FINMA will evaluate and weigh any comments received and provide a report on implementing these comments into the circular.

Based on the consultation process, the new circular on the rules of conduct under FinSA and FinSO shallbe finalised. FINMA plans for the circular to enter into force at the beginning of 2025.

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