Financial Services Act (FIDLEG)

Impact on the value chain and strategic implications

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Editorial

In November 2015, the Federal Council adopted the dispatch on the Financial Services Act (FIDLEG) and the Financial Institutions Act (FINIG). The drafts of the acts were discussed in the Council of States in December 2016 and has now been discussed in the National Council during its autumn 2017 session. Unlike the initial drafts and MiFID II, the current versions offer pragmatic implementation options. We expect the acts to enter into force in the first half of 2019.

The aim was to create a regulation on par with EU regulations that takes account of Swiss specific conditions and provides investors with sufficient protection. In contrast to the European Union, the Federal Council is seeking to implement principle-based rules.

During the parliamentary debates, legislators deviated somewhat from their original objective of having financial service providers to comply with a standard as uniform as possible for both Swiss and European clients.

The well-intentioned suggestion that the central issues be dealt with less extensively than international industry standards may, upon closer analysis, have unintended consequences.

For international providers, the draft offers both the opportunity and the operational challenge that standards for Swiss and non-European clients differ from the ones that apply for European clients. Consequently, they must decide whether to apply the current MiFID processes to Swiss clients or to introduce parallel processes with the corresponding implementation consequences and operational challenges.

This publication offers an initial analysis of the current legal framework and the ongoing discussion in parliament. We outline the resulting need for action by financial service providers along the value chain and also discuss some strategic issues.

We look forward to discuss individual aspects with you in detail.
FIDLEG — At a glance

FIDLEG ensures uniform competitive conditions for the provision of financial services in connection with financial instruments. However, insurance companies and reinsurers were taken out from the original version of the dispatch. Corresponding provisions are to be included in separate insurance specific statutory regulations.

Among the key changes are (i) new organisational requirements, (ii) substantially expanded rules for investment advice and (iii) the requirement to provide a basic information sheet when selling financial instruments.

The planned dual standard, under which the rules of conduct in accordance with supervisory law will also be valid for civil law, will provide improved legal certainty.

FIDLEG will enter into force at the same time as FINIG, which will regulate the activities of asset managers and trustees, in particular, more stringently.

The introduction of FIDLEG will have a substantial impact on the core processes of investment advice and asset management. The requirements and interdependencies must be recognised and integrated efficiently in current processes. Institutions with an international focus must also take account of the significant similarities with Europe’s MiFID II as well.

FIDLEG affects financial service providers in Switzerland, such as:
- Banks
- Securities firms
- Asset managers
- Issuers of financial instruments

The rules of conduct go well beyond the rules that apply now:
- Expanded information and documentation obligations
- Review of financial services to ensure they are appropriate and suitable
- Transparency and due diligence when carrying out client orders

In future, a basic information sheet will be required in most cases in order to sell financial instruments.

In addition, there will be an expanded obligation to provide a prospectus for publicly offered securities. In future, prospectuses will have to be submitted to an inspection authority.

Clients will be divided into three segments:
- Institutional clients
- Professional clients
- Retail clients

Appropriate organisational measures must be taken:
- Ensure training of client advisors
- Avoid conflicts of interests, incl. publication of compensation paid to third parties
- Monitor service provider chain

Registration requirement for domestic and foreign client advisors not subject to the Swiss Financial Market Supervision Act

Financial service providers

Advisor registration

Organisation

Sale of financial instruments

Client segmenting

Rules of conduct

Financial service providers

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Core processes – Need for action

The new FIDLEG provisions cut to the heart of the investment advisory and asset management business. One focus is on the time when the investment advice is provided (point of sale), as the information that the client receives during the advisory process must be reviewed against the products offered by the financial services provider to ensure that it is suitable. Thus, the point of sale is where the advisory process and the product process meet. In addition, FIDLEG will affect the entire value chain in the area of investment advice, asset management and the issuance of financial instruments.

Our experience has shown that the obligations shown below in simplified form as well as the other organisational requirements will, depending on the institution, have a significant impact on the current target operating model.

A preliminary impact analysis will help to identify all areas of activity and ensure the efficient use of resources.

With respect to the similar, but much more extensive requirements of the Markets in Financial Instruments Directive (MiFID II), which member states must implement by 3 January 2018, we see various approaches in the industry. While some providers view the regulatory requirements as merely a cost-intensive obligation, other financial services providers have taken the opportunity to reconsider and modernise their advisory processes. They integrate the new requirements in their processes in a standardised and automated manner to the extent possible. This relieves client advisors of many administrative burdens and puts the focus on the client experience.

Before the agreement is concluded, the client must receive information about the financial services provider, its services and the related risks and costs.

All clients must be assigned to one of three categories. For retail clients, the investment objectives, financial circumstances and product experience must be documented.

The client must be given a basic information sheet. The prospectus is only to be handed out upon request.

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### Client level

**Onboarding**

- **General information obligations**
- **Client profiling**
- **Client information**

### Product level

- **Product universe**
- **Product classification**
- **Product information**

The product universe for investment advice and asset management must be defined. The relevant market offering must be described.

The financial products must be assigned to a risk class for subsequent comparison with the client profiles. Alternatively, a portfolio approach can be applied.

The basic information sheets and, if necessary, prospectuses must be created for own products or, for third-party products, obtained from the issuer.
Key differences to MiFID II at a glance

- **Cost transparency** – According to MiFID II, all costs must be disclosed to clients before a transaction is conducted. This includes transaction costs as well as the costs included in the product (e.g., profit margin). In addition, under MiFID II very detailed information about all costs must be sent to clients periodically.
- **Retrocessions** – In contrast to MiFID II, FIDLEG does not prohibit the acceptance of benefits (e.g., retrocessions) in connection with asset management.
- **Appropriateness and suitability** – The distinction under FIDLEG 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.
- **Sale of financial products** – MiFID II requires a product approval process for proprietary and third-party financial instruments. In addition, a target market must be defined; this is intended to ensure that financial instruments are sold to the appropriate clients.
- **Best execution** – MiFID II contains extensive requirements regarding best execution of client orders and requires the financial institution to disclose which exchanges it uses the most.

Comparison of the product characteristics with the client profile. The client must be warned if there are any deviations. No review is necessary for “execution-only” transactions.

In addition to regular reviews of product information, automated portfolio monitoring will become the market standard.

Point of Sale

- Appropriateness & suitability
- Client profiling
- General information obligations
- Client information
- Product universe
- Product classification
- Monitoring

Execution & reporting

- Best execution
- Reporting
- Monitoring

The advisory service that has been provided must be documented in advisory minutes.

When a client order is executed, the best possible result financially, qualitatively and in terms of time must be achieved.

Upon request, financial services providers will provide clients with an accounting of the services provided and the related costs.

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Core processes – Need for action

**Onboarding**

**General information obligations**
In future, the new pre-contractual information obligations will be part of the account-opening process.

Before concluding the agreement or providing services, financial services providers will have to provide their clients with clear information about the services and financial instruments they offer and their company. In practice, this will be done via an additional information brochure. Initial cost transparency obligations have been deleted from the draft by the Council of States.

**Client segmenting**
In future, clients must be assigned to one of three client segments:
- Retail clients
- Professional clients
- Institutional clients

The segment determines the applicable level of protection for the client. Clients can declare that they want to be assigned to a different segment and thus benefit from more or less investor protection.

Segmenting can be dispensed with entirely if all clients are treated like retail clients. However, this approach results in restrictions on the sale of products to professional clients.

**Comparison with MiFID**
The client segments generally correspond to the MiFID requirements, but there are some differences and considerable flexibility for reducing the applicable level of protection.

A well thought-out selection from among the available client segment options under FIDLEG seems more attractive. For example, wealthy clients can declare that they want to be treated as professional clients (opting out). This is particularly true for clients with assets of more than CHF 2 million who are already documented as qualified investors in accordance with the size criterion of CHF 5 million in the Collective Investment Schemes Act.

Amongst others, large companies that meet two of the following three criteria can also be considered professional clients:
- Balance sheet > CHF 20 mn,
- Sales > CHF 40 mn,
- Equity capital > CHF 2 mn

The FIDLEG rules of conduct do not apply to institutional clients at all, and they only apply to professional clients to a limited extent. Furthermore, professional clients can largely forgo the application of information, documentation and accounting rights.

**How can opting out support the reduction of the regulatory obligations and to what extent can it be applied?**

**Client profiling**
The scope of information that must be obtained from clients depends on the relevant service and client segment. For the appropriateness check financial services providers only need to determine their clients’ knowledge and experience. The obligation is more extensive with respect to the suitability check and includes checking his or her financial circumstances and investment objectives as well. This information is generally collected using the questionnaire created by the financial services provider, which is usually completed and documented by the client advisor during the onboarding process. The current draft makes the process much easier for purely transaction-based advice compared to MiFID II, as in this case no information regarding the client’s financial circumstances and investment objectives is required in advance.
Financial services providers that provide investment advice or asset management services must carry out an appropriateness and suitability check. These regulatory obligations are based on similar requirements set out in MiFID. However, some relevant conceptual differences exists:

**Execution-only business**
If a financial services provider only conducts execution-only orders or orders on the basis of client instructions, FIDLEG allows it to dispense with the appropriateness and suitability check entirely. Under MiFID, this is only possible to a limited extent in the case of execution-only business for non-complex financial instruments.

**Appropriateness and suitability check**
While MiFID always requires a suitability check if investment advice or asset management is provided to retail clients, FIDLEG distinguishes between financial services providers who conduct advisory services related to individual transactions and those who manage and advise on the client’s portfolio. There is no detailed information regarding the differences in practice between these two scenarios. A suitability check is always required in an asset management scenario. However, there is no uniformity as regards advisory services. Making a clear distinction between these scenarios, which have different consequences under supervisory and civil law, is one of the challenges of putting this concept into practice.

**Exemption from the suitability check**
A financial services provider can be exempted from the obligation to carry out a suitability check if it informs clients before providing the service that it cannot make an assessment due to a lack of information or if it advises against the service. This stands in contrast to the principle specified in MiFID that financial services providers cannot offer personal recommendations if a positive suitability check has not been carried out in advance. Consequently, under the FIDLEG concept a financial services provider can also provide advice regarding unsuitable financial instruments. In our view, however, the aforementioned scenario does not offer enough room for investment advice and will likely generally fall into the category of non-advised business.

**Cost transparency**
One of the major challenges of MiFID is the cost transparency required before conducting each transaction. This requirement is not included in the current draft of FIDLEG, which represents a significant advantage compared to the European regulation. However, it remains to be seen whether greater transparency in Europe increases pressure on Swiss financial services providers to offer more cost transparency.

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**Different concepts**
MiFID does not distinguish between portfolio-based and transaction-based advice. By contrast, with execution-only business the complexity of the product must be taken into account. How to combine these two approaches?
Legal certainty for banks

The original idea of making it easier to enforce consumer claims was soundly rejected during the parliamentary debate.

Because FIDLEG is intended to serve as a dual standard, effective under civil law as well as supervisory law, the current proposal offers banks an attractive level of legal certainty. If the FIDLEG requirements are met (e.g., correct client classification and legally valid waiver of retrocessions), banks can reduce their exposure of legal liability in future legal disputes significantly.

Sidebar: Rule engine

FIDLEG increases requirements at the point of sale. However, the current requirements regarding the appropriateness of products from a tax and regulatory viewpoint as well as compliance with the restrictions on cross-border financial services must also be taken into account.

Advanced rule engines combine these various requirements and support client advisors in providing legally compliant advisory services.

How can liability risks be avoided when distinguishing between transaction-based and portfolio-based advice?
Core processes – Need for action

**Execution & reporting**

**Best execution**

Client orders should be conducted in the best interests of the client. An order should achieve the best possible overall result for the client (i) financially, (ii) qualitatively and (iii) in terms of time.

In liquid markets the focus is generally on price and the costs associated with the transaction. The speed of execution is mainly relevant in illiquid markets. With respect to quality, the primary focus is on counterparty risk.

Financial services providers face the challenge of weighting the non-price-related criteria and including them in their systems. In addition, data about expected transaction costs and taxes at foreign exchanges must be maintained systematically and included in the price.

**Documentation & accounting obligations**

The advisory minutes that are now required as part of the sale of collective investments are generally being expanded to financial instruments. Current approaches in the market show that the minutes can be completed automatically by using the information obtained as part of the appropriateness and suitability check, thus keeping the amount of administrative work low.

The Federal Council has provided for two other major changes in its dispatch.

- Upon request, financial services providers will be required to provide clients with a copy of the documentation they have on the financial services provided, any warnings and the advisory minutes.
- Second, the costs associated with the financial services provided must be disclosed to clients, likewise on request. The experience with similar requirements in Europe shows that creating cost transparency should not be underestimated and that it results in additional requirements in terms of data availability and granularity.

However, FIDLEG also allows for simplified approaches if the client agrees to it.

How can the potential conflicts of interest between time, costs and quality be reconciled in the framework of best execution?
Core processes – Need for action

**Product level**

**Product universe and classification**

The prerequisite for the product process is the product universe that can actively be offered to the client. In order to ensure that suitability and appropriateness checks are carried out systematically, all products in the universe should be assigned to a risk class. Otherwise, the product risk characteristics can also be assessed in the context of the client's portfolio based on statistical methods.

**Product information**

The provisions in FIDLEG regarding the prospectus obligation replace the current rudimentary provisions in the Swiss Code of Obligations. In general, every public offer of securities triggers the obligation to provide a prospectus, including some derivatives and structured products as well. Noteworthy exceptions to this prospectus obligation include, in particular, (i) public offers that are only intended for professional clients or (ii) less than 500 clients, (iii) that require a minimum purchase of CHF 100,000 or (iv) do not exceed a total volume of CHF 2.5 millions.

If financial instruments are offered, a basic information sheet is required. The fundamental element of this basic information sheet is a clear summary of the key product features. This principle is familiar to us from the Key Investor Information Document (KIID) required under the Collective Investment Schemes Act. Comparable foreign information sheets are also accepted.

The basic information sheet must be given to private clients receiving advice before the agreement is signed or concluded. In certain cases, this may also be done subsequently with the client's consent. Similar requirements in the EU show that such information is generally provided electronically.

One challenge banks face is the considerable number of relevant products and how to provide the corresponding information to clients before orders are executed. In order to avoid time-intensive documentation work the information should be provided automatically, at least for non-standardised products (e.g., currency forwards).

**PRIIPs sidebar**

Starting on 1 January 2018, providing advice about or selling financial instruments to clients in the European Economic Area will also require a PRIIPs* KID. Institutions should try to leverage the synergy potential of the regulations now.

* Packaged Retail and Insurance-based Investment Products

**Monitoring**

Issuers must review the information contained in the basic information sheet on a regular basis and, if necessary, update it. For their part, financial services providers must ensure that they have the current version of these sheets when offering financial instruments.

FIDLEG does not include a requirement regarding periodic monitoring of the client portfolio. However, over the past few years some market participants have invested heavily in a qualitative expansion of their advisory process. They are already monitoring the agreed investment strategy against the actual client portfolio on a daily basis and responding proactively in the event of deviations.

How can the information obligations be integrated seamlessly in the buying process?
Outlook

Practical challenge of implementation for international providers
Larger international financial institutions have already adopted parts of MiFID I and are now working on implementation of the enhanced regulation (MiFID II). Correspondingly, these institutions have adapted, among other things, their advisory processes, their rules on conflicts of interest and their client communications. It is clear that these institutions will rely to a great extent on current solutions when implementing FIDLEG. Deviations will be particularly worthwhile if certain client categories can be fully exempted from the obligations or if the administrative burden can be reduced in general.

Equivalence of the regulations
A central question for the Swiss financial centre is whether the current version of FIDLEG will be accepted by the EU as equivalent to MiFID II, thus creating the condition for better market access. FIDLEG follows the Swiss tradition of principle-based legislation. By contrast, MiFID II is more heavily rule-based and thus much more comprehensive and, in some cases, more stringent. Overall, however, both regulations follow the same principle. In addition to equivalence, market access will likely also depend on the negotiations regarding general collaboration with the EU.

Current discussions in parliament
The parliamentary discussion will show how closely legislators want to align the consumer protections of MiFID for the sake of market access. The major cornerstones have now been laid. The National Council has completed its debate in the last autumn session. The differences with the Council of States could be reconciled during the winter session, but this is more likely to take place in the spring 2018 session. At present, there is talk of the law entering into force on 1 January or 30 June 2019. However, this depends in large part on the results of the further discussions in the two councils.
Our offering

EY helps many financial institutions in Switzerland and Europe analyse and implement MiFID II. Our clients benefit from this experience and our proven structuring approach.

The services we offer in connection with FIDLEG include the following:

**Implementation support**

- EY provides an experienced team
- Impact/gap analysis as well as implementation support
- Additional resources, including complete project management, depending on the need

**Training**

- Assistance with the preparation of training documents and web-based training sessions
- We can conduct the training and webcasts

**Coaching**

- EY provides experienced sparring partners for the steering committee
- We can lead the workshops
- Support for difficult questions
- Benchmarking

**Health check**

- EY conducts health checks and reviews the planned approaches with respect to compliance and market practice
- Heat map and gap reports show the potential risks and implementation gaps
About EY
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