NKF Client News

25 AUGUST 2022

New Self-Regulation for Financial Service Providers on the Integration of ESG Preferences at the Point of Sale – Selected Aspects

On 16 June 2022, the Swiss Bankers Association (SBA) adopted "Guidelines for the financial service providers on the integration of ESG-preferences and ESG-risks into investment advice and portfolio management" (Guidelines), which will enter into force on 1 January 2023 (with transition periods). This is the first time that binding self-regulation focusing on ESG will be introduced at the point of sale. A real innovation is the obligation to enquire and consider ESG preferences of clients when providing investment advice and portfolio management. This Client News highlights important contents, cross-references and pitfalls of the new self-regulation.[1]

1. Scope of Application of the Guidelines

1.1 Personal

The member institutions of the SBA are automatically subject to the Guidelines and obliged to comply therewith. Non-members may join the Guidelines voluntarily (art. 2 Guidelines). For non-members, such as external portfolio managers and investment advisors, joining the Guidelines may be considered especially for competitive reasons, as the demand of investors for sustainable financial products is steadily increasing and joining the Guidelines represents a quality label. The Guidelines can be qualified as so-called voluntary self-regulation, which has a purely private autonomous effect. Recognition by FINMA as a minimum supervisory standard within the meaning of art. 7 para. 3 FINMASA does not appear to be envisaged (and rightly so). This is due to the fact that there is no corresponding (supervisory) legal basis in the area of sustainability.

However, even for non-members who do not join voluntarily, the Guidelines could be of importance in the future insofar as they could be considered as industry standard by civil courts when assessing the objective standard of due care (see below 5.1).

1.2 Type of service

The Guidelines are applicable when providing investment advice and portfolio management. Other financial services according to art. 3 let. c FinSA are excluded. This is consistent, as the inclusion of ESG preferences and ESG risks only concerns these services. By requiring to collect ESG preferences also in the process of transaction-related investment advice (explicitly art. 11 para. 3 Guidelines), the Guidelines clearly go beyond the assessment of appropriateness according to FinSA, since art. 11 FinSA does not (at all) provide for a duty to consider investment objectives in the appropriateness assessment.

[1] Accordingly, the Client News only deals with individual aspects of the Guidelines and do not present their content comprehensively.

1.3 Local

FinSA and FinSO apply *mutatis mutandis* to define the local scope of application of the Guidelines (art. 2 para. 1 Guidelines). They therefore apply to investment advice and portfolio management mandates performed in Switzerland or for clients in Switzerland (cf. art. 3 let. d FinSA); foreign financial service providers, however, are likely to join the Guidelines rather rarely, so that the latter constellation will not be frequent (but see 5.2).

1.4 Temporal

The Guidelines will enter into force on 1 January 2023. For internal implementation by the institutions, transition periods will apply until 1 January 2024 in relation to new client relationships as well as staff training and development, and until 1 January 2025 in relation to (at the beginning of January 2023) existing client relationships. As soon as the Guidelines will have been implemented by the individual institution, they will replace the SBA "Guideline for the integration of ESG-considerations into the advisory process for private clients" of June 2020 (art. 18 Guidelines).

2. Information about ESG Risks

According to art. 10 para. 2 Guidelines, where ESG investment solutions are concerned, financial service providers shall inform clients about the ESG risks[2] and characteristics associated with financial instruments or financial services as part of the general risk disclosure. In our opinion, however, this obligation is a mere clarification of what already results from statutory law. Thus, based on art. 8 para. 2 let. a FinSA and art. 398 para. 2 CO, a financial service provider must inform its clients about those ESG risks which result in a substantial financial risk.

3. ESG Preferences as "Top up"

A true innovation is the obligation to (actively) enquire about the clients' ESG preferences and take them into consideration in investment advice and portfolio management (art. 11 and 12 Guidelines). In this regard the Guidelines go beyond the regulation of FinSA. The Federal Parliament had discussed and explicitly rejected the inclusion of an obligation to enquire about sustainability preferences into FinSA.[3] Self-regulation now requires member banks and joined financial service providers to enquire about ESG preferences as part of the assessment of appropriateness and suitability. If clients express specific ESG preferences, these must be taken into account in the context of investment advice and portfolio management.

However, the Guidelines state that ESG preferences should not take precedence over the clients' overriding investment objectives (art. 11 para. 5 and art. 12 para. 1 Guidelines). The ESG preferences thus have - in line with the European regulation[4] - a "top up" character: They only come into consideration in a second step when the financial service provider has ensured that a financial instrument is generally suitable for the client on the basis of the financial investment objectives assessed in accordance with art. 17 para. 2 FinSO. If there is a conflict between the overriding financial investment objectives and any ESG preferences, the former therefore take precedence. If in such a case financial instruments deviate from the ESG preferences expressed by clients, e.g., because no ESG-related alternative is available for the required asset class, this must be "clearly highlighted and communicated" to the clients in the relevant investment recommendation (art. 12

[2] According to art. 8 para. 1 let. g Guidelines, ESG risks are "current or future consequences of ESG-criteria that could have a positive or negative effect on the value of investment solutions".
[3] Cf. Official bulletin 2017 N 1294 et seqq.
[4] Cf. ESMA, Guidelines on certain aspects of the MiFID II suitability requirements, Consultation Paper of 27 January 2022, no. 18 et seqq.

para. 3 Guidelines). Such transactions may only be executed after the clients have been informed of this deviation.

4. Scope of Implementation

The new Guidelines do not define what is meant by "ESG preferences". Due to the lack of a general definition of sustainability or rather an ESG taxonomy in Swiss law, financial service providers enjoy a wide margin of discretion when implementing the Guidelines. Ultimately, institutions must implement their own ESG methodology.

For internationally active banks in particular, alignment with European regulation may likely be wise, if not indispensable. The European regulation defines in the revised art. 2 no. 7 Delegated Regulation 2017/565[5] in force as of 2 August 2022 the term "sustainability preferences" on the basis of specific criteria by referring to the EU Taxonomy Regulation[6] and the EU SFDR[7].

Under Swiss law, the new "Swiss Climate Scores", which were introduced by the Federal Council on 29 June 2022, must be taken into account. Based on six climate-related indicators, they are designed to help provide investors with meaningful and comparable information on the climate compatibility of financial investments. At least with regard to the "E" of ESG, there is thus also certain guidance for financial service providers in Swiss law. While the "Swiss Climate Scores" are not binding, the Federal Department of the Environment, Transport, Energy and Communications (DETEC) and the Federal Department of Finance (FDF) are currently evaluating the need for regulation (especially at the point of sale) in the area of sustainable finance. A corresponding report is expected by the end of 2022.

5. Legal Risks

5.1 Civil Law

The Guidelines do neither create nor abolish any obligations under civil law. However, it is possible that in the future civil courts may deem them to be the relevant industry standard when assessing the objective standard of due care. Accordingly, financial service providers are likely to expose themselves to a civil liability risk if they do not enquire about the ESG preferences of their clients in the context of investment advice and portfolio management after the transitional periods have expired, unless this was explicitly excluded by contract.

Additionally, if the client expresses ESG preferences, the risk exists that the client could claim such preferences to have been incorrectly implemented. In the event of a dispute and due to the lack of a standard definition of sustainability, the courts would have to interpret the contract between the financial service provider and the client. We would therefore recommend that both the ESG methodology used and the relationship of the ESG preferences to the financial investment objectives be explicitly stated in the service agreement (see also 5.2). It would admittedly be difficult to prove that damage was causally caused by the disregard of an ESG preference. However, there is a risk that the client could invoke a legally relevant error in the individual case. If such argument succeeded, the investment transactions carried out vis-à-vis the client would be invalid *ex tunc* and thus reversed (irrespective of any pecuniary loss). Contractual documentation and advertising for ESG financial services and ESG products should be drafted with this in mind.

[5] The Delegated Regulation (EU) 2017/565 was amended by the Delegated Regulation (EU) 2021/1253.
[6] Regulation (EU) 2020/852 of 18 June 2020.
[7] "Sustainable Finance Disclosure Regulation"; Regulation (EU) 2019/2088 of 27 November 2019.

5.2 Supervisory Law

As shown, there is no obligation to enquire about the clients' ESG preferences based on FinSA *de lege lata* (see above 3.). However, if ESG preferences are collected (voluntarily or in future on the basis of the Guidelines) and the financial services provider subsequently violates them when providing investment advice or portfolio management services, it risks violating art. 12 FinSA by selecting a financial instrument unsuitable for the client. ESG preferences expressed by the client fall under art. 12 FinSA, because the assessment of suitability is not limited to financial investment objectives (cf. also art. 17 para. 2 FinSO; if a client declares that he or she does not want any non ESG-compliant investments, there is arguably an investment restriction pertinent). Accordingly, the risk of a violation of art. 12 FinSA also exists for (foreign) financial service providers who are not subject to the Guidelines but voluntarily enquire about the ESG preferences of their clients (FinSA also applies to foreign financial service providers who provide financial services on a purely cross-border basis to clients resident in Switzerland; cf. art. 3 let. d FinSA and already 1.3 above).

Furthermore, the question arises as to whether the procedure stipulated in the Guidelines regarding a deviation from the ESG preferences is compatible with FinSA. As shown, the Guidelines allow the financial service provider to actively deviate from the ESG preferences if it informs the client prior to executing the transaction (art. 12 para. 3 Guidelines). However, according to art. 12 FinSA, the financial service provider shall *a priori* not recommend or select a financial instrument that is not suitable for the client based on the agreed investment strategy. Moreover, art. 14 para. 2 FinSA cannot be applied *mutatis mutandis* to this constellation, since according to this provision the financial service provider must *advise against* the unsuitable financial instrument; a mere information of the deviation from the preferences, as provided for in art. 12 para. 3 Guidelines, is not sufficient.

In order to prevent a supervisory risk, it is therefore also (see already 5.1 above) recommended that the relationship of the ESG preferences to the financial investment objectives be explicitly defined with the client as part of the agreement on the investment strategy (cf. art. 17 para. 3 FinSO) on the basis of specific investment guidelines. In particular, it should be agreed whether ESG preferences may be deviated from if a diligent investment based on the financial investment objectives requires such deviation (e.g., if no ESG-related alternative is available for the required asset class). In this case, the "deviation" from the ESG preferences does not constitute a violation of art. 12 FinSA. In this way, the (alleged) contradiction between the Guidelines and the FinSA can be resolved.

5.3 Criminal Law

If a violation of art. 12 and art. 14 para. 2 FinSA (only) in the sense described just above is to be assumed, there is also a risk in terms of criminal law. According to art. 89 let. b FinSA, anyone who willfully violates the duties according to art. 10–14 FinSA in a severe manner shall be fined up to CHF 100,000. Provided that a breach of ESG preferences by a portfolio manager results in a determinable pecuniary loss to the client in the individual case (which, however, is unlikely to be the case; see 5.1 above), there is further a risk of liability for criminal mismanagement (art. 158 CC).

6. Conclusion and Next Steps

The new obligations to enquire about the ESG preferences of clients and to take them into account when providing investment advice and portfolio management as well as the associated legal risks require member banks and joining financial service providers to carefully implement the new Guidelines. The necessary implementation effort depends on whether and, if so, to what extent a financial service provider has already until now (voluntarily) taken ESG client preferences into account. It should be noted that even processes that already take ESG preferences and risks into account must be checked for conformity with the new Guidelines and, if necessary, be adapted (as stated explicitly in art. 6 Guidelines).

The effort to implement the Guidelines should not be underestimated. The organisational changes (if necessary, adaptation of the internal processes, revision of directives, etc.), the possible necessary adjustment of contracts, the training of employees and the implementation of an internal ESG methodology (or, if applicable, the adaptation of an already existing methodology) are likely to cause a large workload. Although the Guidelines provide for transition periods until 2024 respectively 2025, their implementation should therefore be initiated as soon as possible.

If you have any questions, please do not hesitate to contact your regular NKF contact or the Banking, Finance & Regulatory team.

Authors

Sandro Abegglen
Partner, Head Banking, Finance & Regulatory
sandro.abegglen@nkf.ch

Lukas Fahrländer
Associate, Banking, Finance & Regulatory
lukas.fahrlaender@nkf.ch