Social Trading

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The ongoing digitization of the financial services markets and the near ubiquitous availability of smartphones and mobile broadband internet resulted in a rise of digital-only financial service providers over the recent years. Unlike their more traditional "brick and mortar" competitors, these new financial service providers offer their services almost exclusively through digital channels and at significantly lower costs, making financial services, in particular securities trading, available to a broad base of retail investors. Combine this phenomenon with social media features, such as influencers, and the result is social trading. In this article, we take a closer look at the Swiss financial market regulatory aspects of social trading.

By Patrick Schärli / Patrick Schleiffer

1) What is social trading?

The core of social trading is the idea of making one's trading behavior and past trading returns (or losses) visible to others, be it your friends or any other followers. The transparency over the trading behavior allows friends, followers and other peers to copy or mirror trading activities of other users of the relevant social trading platform. In many ways, following a trusted peer or other expert trader with copy trading or mirror trading can be seen as a low-cost alternative to traditional portfolio management offered by incumbent financial services providers.

Social trading is usually offered through easy to access digital channels, allowing the operator of the social trading platform to offer the securities trading services, in particular trade execution, at low prices. Besides the competitive pricing, one of the key appeals of social trading is that it requires little or no knowledge about financial markets on the part of the regular user of such platforms; analyzing financial and fundamental data of potential investments is replaced by selecting and following trusted peers or expert traders. Social trading is, thus, particularly interesting for retail clients.

In this article, we use the term ***Popular Trader*** for those traders that other users of the platform follow (one can think of them as the equivalent of social media influencers). The term ***Copy Trading*** refers to the technique of copying selected trades of a Popular Trader and the term ***Mirror Trading*** refers to the automatic copying of all trades made by a selected Popular Trader.

In this article we discuss social trading platforms that offer to their clients the full range of trade services and that hold the relevant financial instruments for their clients. It would, however, also be conceivable that a social trading platform limits itself to providing a platform for users to share their trading strategies or portfolios, without also offering trade execution services.

2) Regulation of social trading platform operators

a) Licensing requirements

A social trading platform offers its users execution capabilities for securities trading. A social trading platform also maintains client accounts and holds securities for the account of its users. Additionally, a social trading platform holds cash deposits for its users (*i.e.* the not invested amounts), although some social trading platforms do not offer this service directly, but rather through a licensed bank.

Often, social trading platforms offer complex financial instruments (such as derivatives, structured products, CFDs) in order to enable platform users to mirror (synthetically) a portfolio of a Popular Trader and allowing the platform users to approximate the asset distribution and weighting of the portfolio they mirror. These types of financial instruments are typically issued by the social trading platform (*i.e.* the platform or one of its affiliate acts as counterparty).

From a Swiss law perspective, executing securities transactions for clients and maintaining securities accounts for clients are activities that require a securities firm (*Wertpapierhaus*) license under the Financial Institutions Act (***FinIA***). Additionally, issuing certain types of derivatives (namely standardized and mass-tradeable derivatives) and publicly offering such derivatives is an activity that is reserved for banks and securities firms. Whether or not the financial instruments issued by social trading platforms fall within this type of reserved activity would have to be assessed on a case-by-case basis given that some of these instruments are tailored to relevant users of the social trading platform and/or have limited tradability.

As far as holding cash positions of platform users is concerned, such activity may qualify as accepting deposits from the public, an activity that is subject to licensing requirements under the Swiss Banks and Savings Banks Act (***BankA***). If such cash positions are merely held temporarily for the purposes of settlement of transactions, the relevant cash positions do not qualify as deposits pursuant to an exemption under the Swiss Banks and Savings Banks Ordinance. If the relevant platform operator is licensed under the BankA, no additional securities firm license is required under the FinIA. Having said that, the internal organization of such a licensed platform operator would still have to be adequate for both the banking type of business (*i.e.* the acceptance of customer deposits) and the securities firm business (*i.e.* securities trading, issuing of derivative instruments).

The aforementioned licensing requirements under the BankA and the FinIA apply to Swiss-based financial institutions. As far as non-Swiss financial institutions are concerned, licensing requirements under the BankA and the FinIA are triggered only if such non-Swiss financial institution maintains a permanent physical presence (*e.g.* a branch or a representative office) in Switzerland. In the absence of such permanent physical presence in Switzerland, pure cross-border offerings of non-Swiss financial institutions are not generally not subject to licensing requirements under Swiss financial markets laws (with the exception of certain consumer financing activities and the offering of insurance products or if such non-Swiss financial institutions were also to become a direct participant of a Swiss trading venue).

Social trading platforms are typically not operating out of Switzerland, but are rather addressing the Swiss market on a cross-border basis through a digital service offering. Consequently, such non-Swiss operators of social trading platform are typically not subject to licensing requirements in Switzerland.

b) Financial services regulation

Separately, Swiss law dictates the rules on providing financial services to Swiss clients. These rules, which are set out in the Financial Services Act (***FinSA***) and its implementing ordinance (***FinSO***) apply irrespective of whether or not the relevant financial service provider is based in Switzerland or outside of Switzerland. Thus, also non-Swiss operators of social trading platforms have to assess their obligations under the FinSA when offering financial services to Swiss-based clients.

Under the FinSA, the term "financial service" includes the following activities:

– acquisition or disposal of financial instruments (essentially, this refers to execution of orders in financial instruments for clients);

– receipt and transmission of orders in relation to financial instruments;

– administration of financial instruments (portfolio management);

– provision of personal recommendations on transactions with financial instruments (investment advice); and

– granting of loans to finance transactions with financial instruments (the focus being on margin loans, Lombard loans and similar type of transactions).

FinSA defines "financial instruments" broadly to include shares, bonds and other debt instruments, derivatives, structured products, funds (including ETFs) and certain structured products. Many of these type of instruments can be traded on social trading platforms.

i. Social trading platforms are offering financial services

For purposes of the FinSA, social trading platforms qualify as a financial service provider given that they execute orders in financial instruments for clients in Switzerland (for purposes of the FinSA, a "client in Switzerland" is a client that is either (a) an individual that is permanently resident in Switzerland, (b) a legal entity that is incorporated in Switzerland, or (c) a Swiss branch of a non-Swiss legal entity). While the FinSA provides for a reverse solicitation exemption, such exemption is rather narrow and it is not applicable in cases where a financial service provider specifically addresses the Swiss market (*e.g.* through a website that is also directed to potential Swiss clients).

Besides acquiring or disposing of financial instruments for clients or transmitting orders in financial instruments to an execution broker, social trading platforms may also be considered as engaging in portfolio management. This is particular true in case of Mirror Trading, *i.e.* where the client authorizes the social trading platform to automatically execute transactions in financial instruments based on the portfolio and the trading activity of a Popular Trader. In this respect, the FinSA analysis is similar to those in the UK or under European regulations (see for example the assessment of copy trading by the United Kingdom Financial Conduct Authority (<https://www.fca.org.uk/firms/copy-trading>; last accessed on 16 March 2021) or the position of the European Securities and Markets Authority (ESMA) in response to question no. 9 of its MiFID Questions and Answers, Investor Protection & Intermediaries (>https://www.esma.europa.eu/sites/default/files/library/2015/11/2012-382.pdf>; last accessed on 16 March 2021)).

ii. FinSA obligations applicable to social trading platforms

Under the FinSA, also non-Swiss financial service providers are subject to rules of conduct (*e.g.* information obligations, best execution, suitability and appropriateness assessments (in case of investment advice or portfolio management), document retention obligations) as well as certain organizational requirements. In addition, financial service providers are required to categorize their client: Similar to MiFID II, the FinSA provides for a client categorization, consisting of three different types of investors, namely private clients, professional clients, and institutional clients. No client categorization is required if all clients are treated as private clients, which we expect to be typically the case for social trading platforms given their focus on retail clients.

To the extent a non-Swiss financial service provider (such as a social trading platform) is already subject to comprehensive financial services regulation outside of Switzerland (in particular in the EU or in the United Kingdom), the question arises whether such a non-Swiss financial service provider can rely on its home country conduct and organizational rules and requirements, instead of applying similar rules laid out in the FinSA. While the FinSA does not provide for an explicit substituted compliance regime, it was in our view the clear intention of the Swiss legislator that FinSA should not exceed comparable requirements and rules under the European laws and regulations (in particular MiFID II). Accordingly, to the extent a non-Swiss financial service provider complies with MiFID II (and the relevant national implementing laws) when servicing clients in Switzerland, such non-Swiss financial service provider should in our view, for the most part, also meet the requirements of the FinSA. This is in particular true for a client categorization that is equivalent to the FinSA rules (such as MiFID II, which is explicitly mentioned in the explanatory materials to the ordinances implementing the FiniA and FinSA as an equivalent standard).

When applying their home country regulations, non-Swiss financial services provider should, however, be aware that the FinSA provides for a number of specific Swiss features, non-compliance with which may result in enforcement action or criminal proceedings. These specific Swiss features also apply to non-Swiss financial service providers (such as social trading platforms):

- Obligation to disclose retrocessions, kickbacks and similar payments. Such payments need to be either handed over to the client or the client explicitly have to waive claims to such payments;
- Requirement to affiliate with an ombudsman service; and
- Requirement to register client advisors with a Swiss client advisor register.

iii. Ombudsman service

Financial service providers that do not provide financial services exclusively to professional or institutional clients must affiliate with an ombudsman prior to offering financial services in Switzerland. Given that social trading platform are regularly used by and open to retail clients, social trading platforms will be required to affiliate themselves with a Swiss ombudsman service prior to admitting Swiss retail clients to their platforms.

iv. Client advisor register

Under the FinSA, client advisors of non-Swiss financial service providers a required to be registered in a Swiss client advisor register prior to approaching and providing financial services to clients in Switzerland. The term "client advisor" is limited to the individual actually maintaining the client relationship. Individuals in a mere supporting function (such as middle and back office) are not considered "client advisors". The same applies to experts with specific area of expertise, provided they are brought in by the individual that is otherwise responsible for maintaining the client relationship.

Where there is no such individual providing financial services (*e.g.* where a financial service is exclusively rendered through a digital platform), our view is that no client advisor registration is required and that the client advisor registration obligation should not be seen as a "back-door" registration obligation *e.g.* for directors, compliance officers or staff in charge of the technical support that are not actually rendering financial services to clients. Given that social trading platforms typically offer their services through a purely digital platform without human client advisors, our view is that such platforms are in most cases not subject to the obligation of having employees registered in the client advisor register in Switzerland.

However, if a social trading platform also employs actual client advisors within the meaning of the FinSA, it will have to register such advisors in Switzerland if the social trading platform is also offered to individual clients (retail clients) in Switzerland. In this context, we note that while the FinSA provides for an exemption from the client advisor registration obligation for non-Swiss financial service providers that are prudentially supervised in their respective home jurisdiction, such exemption is according to the prevailing view in Switzerland only available if the relevant financial services are exclusively offered to per se professional clients (and not also to HNWIs that have opted to be treated as professional clients under the FinSA) or institutional clients. This is not the case for social trading platforms as they are typically targeting retail clients.

c) Product-level regulation

Separately to licensing requirements and rules applicable to financial services, Swiss law provides for product-level rules and regulations restricting the type of financial instruments which can be sold to Swiss-based retail investors. These product-level rules are of particular relevance for social trading platforms that operate in a multitude of jurisdictions and should be taken into account for determining whether or not a client can copy or mirror trades in certain financial instruments.

Under Swiss law, product-level regulations and restrictions apply in particular to structured products and collective investment schemes. Social trading platforms will need to ensure compliance with such product-level regulations, in particular if mirrored trades relate also to these types of products (*e.g.* a trade in a non-authorized ETF).

i. Structured products

Under Swiss law, product-level requirements apply to structured products (such as capital protected instruments, capped return instruments, or certificates). More specifically, structured products can only be sold to Swiss retail clients the issuer and/or guarantor of such products is either a Swiss bank, insurance company or a securities firm, or a foreign financial institution that is subject to an equivalent prudential supervision. Non-compliance with these rules may result in criminal sanctions.

ii. Collective investment schemes

Under Swiss law, collective investment schemes are defined rather broadly and essentially encompasses any vehicle or contractual arrangement in which investors pool their funds for purposes of collective investments and which is administrated and managed by persons other than the investors; this includes investment funds, mutual funds or ETFs.

Collective investment schemes are subject to rather strict and comprehensive sales restrictions in Switzerland. In particular, offering and sales of collective investment schemes to Swiss retail investors requires that the relevant collective investment scheme is authorized for such purpose by the Swiss regulator FINMA.

iii. Requirement to provide key information documents (KID)

Similar to the PRIIPs regulation, the FinSA provides for a requirement to provide retail clients with KIDs whenever they sell financial instruments with a derivative component. The obligation to prepare a KID applies to manufacturer of relevant financial instruments and, the distributor/seller of such financial instruments is under an obligation to provide a copy of the KID to its retail clients. No KID is required (i) if relevant financial instruments are offered to retail clients in the context of a portfolio management agreement, (ii) for shares and similar equity instruments, including convertible bonds, or (iii) for debt instruments without a derivative element, *e.g.*, straight bonds or floating rate bonds- Instead of a Swiss KID, a PRIIPs KID may also be used.

3) Regulation of the Popular Traders

a) No specific regulations governing general investment recommendations

By allowing others to follow their trading activity and portfolio, Popular Traders can be seen as providing recommendations with respect to financial instrument transactions. In addition, social trading platforms often also have micro-blog or other type of communication features allowing Popular Traders to discuss their trading strategies. This raises the question whether Popular Traders are providing a financial service. In most cases, this will not be the case because the recommendations are general in nature and not personalized for a specific follower. For this reason, the activity of a Popular Trader does generally not amount to investment advice within the meaning of the FinSA and thus, Popular Traders do themselves typically not qualify as financial service providers. The situation could be assessed differently if a Popular Trader responds to specific questions from its followers, although one off-responses to such specific and individualized questions may not meet the "commercial activity" threshold required for financial service providers to fall within the scope of the FinSA.

Unlike other jurisdictions (such as Germany for example), Swiss law does not specifically regulate general recommendations with respect to financial instrument transactions. Having said that, the activities of the Popular Traders are still subject to limitations under applicable market abuse regulations.

b) Market abuse considerations

Regulations against market abuse generally encompass rules against insider trading and against market manipulation. Depending on the number of followers, a Popular Trader needs to be aware that its activities and trading practices could run afoul of rules against insider trading and/or market manipulation. For example, Popular Traders with several thousand followers can potentially influence prices of not particularly liquid stock (as seen in the recent r/wallstreetbets / Gamestop example, coordinated trades of retail traders can significantly influence stock price). A particular issue is front running, *i.e.* where a Popular Trader purchase stocks or options outside of the social trading platform and then later executes a trade in the relevant stock, which is then copied/mirrored hundreds or thousands of times by the Popular Trader's followers.

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SPACs: The Swiss Capital Markets Law Perspective

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On 22 February 2021, luxury electric vehicle manufacturer *Lucid Motors* agreed to go public by merging with the Special Purpose Acquisition Company (SPAC) *Churchill Capital Corp IV* in a deal that valued the combined company at USD 24 billion. While SPACs are a dominant trend in the U.S. (representing 198 out of the 244 IPOs to date in 2021), continental Europe lags behind, with an incipient revival of SPACs in Germany with the IPO of *Lakestar SPAC 1 SE* in February 2021. To date, no SPAC has been incorporated in Switzerland and listed on Swiss stock exchanges. However, this might be about to change, not least because of the revision of the law on joint-stock corporations. Against this background, this article briefly highlights the key aspects of a SPAC-transaction and discusses three selected issues these vehicles have to face in Swiss capital markets law and regulation.

By Claude Humbel / Thomas van Gammeren

1) SPACs: An Overview

a) Preliminary Remarks

SPACs are companies formed to raise capital through an initial public offering (IPO) for the exclusive purpose of using the proceeds to acquire one or more unspecified business or assets to be identified after the IPO in a business combination.

b) Brief Timeline of a SPAC-Transaction

i. Pre-IPO-Phase

In the formation phase, financial sponsors assemble a management team and fund an equity stake in the SPAC. The equity investment then funds the initial business operations to launch an IPO. Although the ratio can vary, the founders' stock customarily represents approximately 20% of the post-offering stock.