

BULLETIN APRIL 2021

Duties and obligations of financial service providers in relation to retrocessions

I. INTRODUCTION

While retrocessions (or inducements) are common in the banking industry they are nevertheless very sensitive. Swiss courts are often faced with claims raised by clients against their wealth manager or banker who did neither disclose the retrocessions received from a third-party to the client nor give them back to the client.

Case law rendered by the Swiss Supreme Court has dealt with both civil and criminal consequences of such behaviors. The recent Federal Act on Financial Services (**FinSA**) which entered into force on January 1, 2020 sets out also new obligations for financial service providers.

This publication is aimed at summarizing the duties and obligations of financial service providers in relation to retrocessions. We will review the civil, criminal and regulatory legal framework.

II. DEFINITIONS

Retrocessions are usually defined as a mechanism pursuant to which someone passes on to a third-party a part of the amount charged to the client on the basis of an agreement.

Retrocessions may take various forms such as:

- Payment of a finder's fee, defined as the fee paid by a bank or a wealth manager to an introducer in exchange of a new contractual relationship;
- Retrocessions paid by the custodian bank to wealth managers calculated as a percentage of the fees charged to the client;
- Payment of a fee by the bank to the wealth manager calculated as a percentage of the client's assets deposited with the bank;
- In respect of hedge funds and structured products, fund promoters frequently remunerate banks or wealth managers in exchange of investments made in the relevant funds or products by passing on a part of the commission charged to the client;
- Retrocessions paid by brokers in relation to structured products calculated on invested amounts.

It is important to underscore that legal issues arising out in connection with retrocessions mainly focus on the party receiving the retrocession (*i.e.*, the wealth manager). This is the entity owing a fiduciary duty towards the client. The paying entity is obviously not obliged to pass on to the client the remuneration earned from the same client! However,

the paying entity, depending on the circumstances, might be accomplice of a crime if the receiving entity is criminally sanctioned (see Section "Criminal Consequences" below).

III. CIVIL DUTIES AND CONSEQUENCES

The entity managing the wealth of clients – which can be a bank – and receiving retrocessions shall abide by the following rules, which are inferred from the contractual relationship with the client.

Duty to fully inform the client in *advance* about the retrocessions:

- A client may validly waive in advance her right to the payment of retrocessions her wealth manager might receive from third parties (e.g., from the bank) if she received full information on the expected retrocessions. The criteria of *full information* is aimed at putting the client in the position to compare (i) the aggregate amount of the retrocessions, to (ii) the fees charged by her wealth manager. By doing so, the client can understand and assess the final amount of the wealth manager's total compensation.
- A client is deemed to be fully informed – and may therefore validly waive in advance her right to repayment of retrocession if she receives information on:
 - The parameters on which the retrocessions are calculated as per the agreement concluded between the wealth manager and the third party; and
 - The range of the expected retrocessions which shall be indicated as a percentage of the assets under management.
- Contractual clauses pursuant to which retrocessions are calculated based on the percentage of the *amounts* or *volumes invested* are not sufficient to hold that the client has been fully informed.

Duty to report the retrocessions received on the client's request. On request, wealth managers are obliged to fully inform the client about the retrocessions he/she has actually received from third-parties. This duty is a prerequisite to the right of the client to claim the payment of retrocessions. In case the wealth manager refuses to give report, the client

is entitled to file a claim before the competent tribunal to obtain the requested information.

Duty to repay the retrocessions:

- As a general principle, wealth managers shall pass on to the clients any sums they have received during the course of their mandate. This duty applies of course to retrocessions.
- The wealth manager and the clients may however derive from such principle. The client may waive in advance her right to claim the retrocessions' repayment. The waiver is however subject to strict information obligations which have been developed above.

Consequences of the breach of the aforesaid contractual duties. The client may claim the payment of retrocessions which do not comply with the strict conditions set out by the Swiss Supreme Court. The client's claim is subject to a limitation period of 10 years as of the day the manager has received the retrocession. In other words, a new limitation period of 10 years starts to run for each retrocession received by the manager.

IV. REGULATORY DUTIES AND CONSEQUENCES

The FinSA contains new provisions regarding financial services providers' duties in relation to retrocessions. These prudential rules are inspired from the case law rendered by the Swiss Supreme Court over the years.

General duty to inform. Before entering into a contract or rendering financial services, financial service providers shall inform the client of any economic relationship they may have with third-parties relating to the proposed financial services. The Federal Council has specified such duty under its Financial Services Ordinance:

- Financial service providers shall provide information on business associations with third-parties insofar as these associations may lead to a conflict of interest in connection with the financial service;
- The information shall include (i) the circumstances giving rise to the conflict of interest, (ii) the risks which the client faces as a result and (iii) the

precautions taken by the financial service provider to reduce the risks.

General duties of care and of transparency. As a general principle, financial service providers must execute the client's orders to provide the best possible outcome in terms of costs, swiftness and quality. On the financial side, they shall consider not only the price of financial products but also (i) the expenses incurred in the execution of the order and (ii) compensation received from third-parties.

Specific duties regarding retrocessions:

- The FinSA defines retrocessions as payments from third-parties accruing to the financial service provider in association with the provision of a financial service, such as brokerage fees, commissions, discounts or other financial benefits
- Financial service providers may accept compensation from third-parties in association with the provision of financial services (e., retrocessions) only if they:
 - have expressly informed the clients on such compensation in advance and the latter waives her right to such compensation; or
 - pass on the compensation to the clients in full.
- The information for the clients must contain the type and scope of the compensation and must be given to them before the provision of the financial service or conclusion of the contract. If the amount cannot be determined in advance, the financial service provider shall inform its clients on the calculation parameters and the ranges. If so requested, the financial service providers shall disclose the amounts effectively received.
- The duty to inform the clients on the retrocessions lies with the party receiving them. In other words, the custody bank which is merely contractually bound to execute the client's orders and which will be paying retrocessions to the manager, has no duties to inform the client about them.

While professional and institutional clients may renounce to various information rights they may have under the FinSA,

they may not renounce to the specific information duties their manager owe to them when receiving retrocessions.

Consequences in case of breach of the regulatory duties. The FINMA may open a so-called enforcement proceeding against the financial service provider to ensure the compliance with the law. At the end of the enforcement proceeding, and provided that the law has been infringed, the FINMA may take the following measures (administrative sanctions):

- Issuance of a declaratory ruling stating that the law has been violated;
- Issuance of a ruling containing remedies. In case the remedies are not complied with within the set deadline, the FINMA may perform the required act itself or have it performed by a third-party at the expense of the defaulting party;
- Issuance of a ruling prohibiting the wealth manager from practicing a profession or an activity;
- In case the breach is serious, the FINMA may publish its ruling.

V. CRIMINAL CONSEQUENCES

Wealth managers may face serious criminal sanctions in the event they do not comply with the aforementioned principles, both from a contractual and regulatory point of view.

We hereby highlight the major criminal risks associated with the retrocessions:

- **Criminal mismanagement** (art. 158 of the Swiss Criminal Code). In 2018, the Swiss Supreme Court found a wealth manager acting as legal guardian of an old lady guilty of criminal mismanagement as (i) he did inform neither his pupil nor the competent authorities about the retrocessions he had received from the custodian bank and (ii) he did not pass them on to the client.
- **Misappropriation** (art. 138 of the Swiss Criminal Code);

- **Private corruption** (art. 322octies and art. 322novies of the Swiss Criminal Code).
- **Fine up to CHF 100,000** (art. 89 §1 lit. c FinSA).

VI. CONCLUSION

Retrocessions entail many risks for wealth managers and other financial service providers. Although the admissibility criteria of retrocessions are not recent (i.e., the first case law goes back to 2006), contractual provisions often do not comply with the strict rules imposed by the Swiss Supreme Court and recently by the lawmaker (see recent case law 4A_355/2019 rendered in May 13, 2020).

We encourage wealth managers and financial service providers to carefully review their contractual clauses to make sure they comply with the strict rules outlined in this publication.

Our team is at your disposal to advise you on any matter you may have regarding retrocessions, or to answer any question you may have in relation to this publication.

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