Update

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Recent Swiss Supreme Court Decision on Retrocessions in the Swiss Financial Industry

The purpose of this note, prepared by Philipp Fischer, is to outline briefly the main findings of a recent judgement of the Swiss Supreme Court, the highest Swiss judicial authority, on the topic of retrocessions (Swiss Supreme Court decision of January 13, 2011 in the case n° 6B_223/2010).

1. Background

In Switzerland, the term *retrocessions* generally refers to certain forms of fee sharing arrangements agreed upon between financial intermediaries (*e.g.*, banks, broker-dealers, portfolio managers, fund promoters, distributors of financial products, etc.).

In a 2006 landmark judgement, the Swiss Supreme Court held that the retrocessions paid to a portfolio manager by the custodian bank holding the client's assets were subject to a statutory restitution duty (Swiss Supreme Court decision of March 22, 2006 in the case n° 4C.432/2005). According to the Swiss court, this duty derives from Article 400 para. 1 of the Swiss Code of Obligations ("**SCO**"), a statutory provision which applies to agency agreements. In practical terms, this means that such retrocessions are, as a matter of principle, due to the client. The Swiss Supreme Court also ruled that this restitution duty is not of a mandatory nature, meaning that it may be varied by the parties (*i.e.*, the portfolio manager and the client) in their private agreement. That being said, according to the 2006 decision, a contractual arrangement whereby the client would agree that the portfolio manager could retain benefits received from third parties (*e.g.*, the custodian bank) in the course of the asset management activities is only valid if (i) the client has been duly informed of the existence of such benefits and (ii) has expressly waived his restitution claim.

The Swiss Supreme Court did not detail in its decision the scope of the information to be disclosed to the client, but this issue was addressed in subsequent cantonal case law.

This 2006 judgement triggered an intense debate as to whether or not this decision could be transposed in the area of collective investment schemes and structured products. In practice, promoters of financial products frequently enter into agreements with other financial intermediaries (typically retail banks or other fund distributors). In this context, the fund promoter or manager generally pays a retrocession to the fund distributor, as a consideration for the distribution services, as well as for certain related services. Generally speaking, such retrocessions may be structured as (i) a percentage of the issuance or redemption fee, (ii) a percentage of the management fee (in German, this type of retrocession is generally referred to as the "Bestandespflegekommission") or (iii) a discount on the issue price in case the distributor underwrites the financial product.

The question as to whether or not this type of retrocession is subject to a restitution duty has been, for the first time, addressed in the recent decision summarized in this note.

2. The Swiss Supreme Court January 13, 2011 decision

The January 13, 2011 decision arose from a criminal case. A bank employee stood accused of criminal mismanagement (Article 158 para. 1 of the Swiss Criminal Code), as he had allegedly embezzled retrocessions that his employer had received from various promoters of structured products. The lower court had considered that, assuming that the alleged embezzlement had not occurred, the bank would not have been authorized to keep the retrocessions and would have been under a duty to pass the same on to its clients. As a result, according to the lower court, the employee could not be held liable for criminal mismanagement *to the detriment of the bank*. Following an appeal lodged by the Zurich Attorney General, the Swiss Supreme Court had to determine whether or not the retrocessions were subject to a duty of restitution to the client. The criminal conviction of the bank employee indeed hinged upon the answer to this question.

In its reasoning, the Swiss Supreme Court emphasizes the distinction between the two contractual relationships existing in the case at hand: first, the contractual relationship in place between the promoter of the structured product and the bank, acting as distributor (*i.e.*, the distribution agreement) and, second, the contractual relationship in place between the bank and the client. Although refraining from characterizing this second contractual relationship under Swiss law, the Swiss Supreme Court nevertheless reviews whether or not the duty of restitution set forth in Article 400 para. 1 SCO (which, as a matter of principle, only governs agency and agency-related agreements) applies in the case at hand. In this context, the Swiss Supreme Court distinguishes this situation from the one that gave rise to the 2006 decision and which related to private wealth management services. In the structured products industry, the recipient of the retrocession (*i.e.*, the bank, which distributes the relevant financial products) renders certain services to the payor of the retrocession. These services, which are set forth in the distribution agreement, include promotional activities in relation to the financial products and assistance in the course of the distribution process. On this basis, the Swiss Supreme Court concludes that the retrocession should be characterized as a *consideration for services* and may thus be kept by the bank.

One can conclude from this case law that, regardless of the arrangements in place with the client, a financial intermediary is entitled to keep the retrocessions received to the extent those retrocessions constitute a consideration for services rendered to the payor of the retrocessions (*i.e.*, the promoter of the structured product).

3. Outlook

This decision of the Swiss Supreme Court clarifies the scope of the 2006 landmark case law – which triggered a significant amount of turmoil in the Swiss financial industry – and brings a certain level of legal certainty as regards the payment flows taking place in the distribution of structured financial products in Switzerland. In our view, the scope of this decision can be extended to the retrocessions paid as part of the distribution, in Switzerland, of collective investment schemes.

The position taken by the Swiss Supreme Court echoes the views expressed by two professional organisations of the Swiss financial industry in the wake of the 2006 decision, namely the Swiss Funds Association in its Circular n° 22/06 dated December 5, 2006 and the Swiss Bankers Association in the 2010 version of its Portfolio Management Guidelines.

That being said, it may well be that the courts have not yet said their last word on the topic of retrocessions: indeed, the 2011 decision was decided upon by the Criminal Law Bench of the Swiss Supreme Court and has not been published in the Official Court Reporter (unlike the 2006 decision, which was rendered by the First Civil Law Bench and was published in the Official Court Reporter).

As a concluding remark, it is worth noting that the question of whether or not a retrocession received by a financial intermediary ought to be passed on to the client only arises if the client relationship is characterized as a Swiss law agency relationship. If this is not the case (typically in an "execution only" scenario), the financial intermediary would, in our view, have good arguments to claim that no (contractual) duty of restitution deriving from Article 400 para. 1 SCO arises and that the various hurdles that need to be cleared prior to being entitled to keep the retrocessions are not applicable.

Financial intermediaries who receive retrocessions and wish to retain those should ensure that the contractual documentation governing their client relationships is drafted in such a way as to minimize the risk of being forced to pass the retrocessions on to the clients. This applies in particular as regards the level of information with respect to retrocessions which is provided to the clients.

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