Retrocessions in advisory and execution-only relationships: the rules are becoming clearer

Our times, and consequently our legislators, attach great importance to managing conflicts of interest. Transparency obligations are implemented to make conflicts of interest visible. The legislator starts from the idea that a disclosed conflict of interest can be managed. These transparency obligations have been introduced in a wide range of fields. For example, members of boards of directors must disclose their conflicts of interest to the board (Art. 717a of the Code of Obligations); members of the Swiss parliament must disclose their interests in full (Art. 11 of the Federal Parliament Act).

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The legal developments of the last few years are part of a fundamental trend to regulate conflicts of interest. In today's social and legal order, it is no longer acceptable for a conflict of interest to benefit the person at the heart of the conflict. This underlying trend will probably lead to further legal developments in the coming years.

Regarding retrocessions in particular, these have been a major concern for independent asset managers for some twenty years. The first significant ruling by the Supreme Court dates back to 2006. Since then, it has been clear that retrocessions must legally be returned to the client, unless the client waives or has waived them. An advance waiver is valid only if the client is informed (at the time of the waiver) of the reference values of the retrocession agreements with third parties and also of the order of magnitude of the retrocessions expected by the client's financial service provider.

These legal principles are easily applied in an asset management relationship, as the client is not involved in the choice of investments. However, they can be difficult to apply in an advisory or execution-only relationship.

In a ruling dated 24 May 2024 (4A_574/2023), the Supreme Court examined the conditions necessary for the validity of a waiver of retrocessions in an execution-only relationship. Although the retrocession waiver clause did not specify the order of magnitude of the expected retrocessions, the cantonal court had accepted the validity of the clause. This clause included the parameters for calculating retrocessions by class of product in the form of ranges, which was deemed sufficient in the context of an execution-only relationship.

The client appealed to the Supreme Court on the basis of the principles repeatedly affirmed by case law, arguing that a waiver of retrocessions was invalid if he was not informed of the order of magnitude of the retrocessions. The Supreme Court clearly understood the difficulty of assessing what retrocessions are in a relationship where orders are given by the client: "in the context of investment advice or execution-only relationships, there are no assets under management that could be used as a base value". And the Supreme Court added: "since the client himself takes the decisions in advisory and execution-only relationships, the principles laid down for asset management cannot be transposed blindly".

Following this ruling, it seems established that in an execution-only relationship, a waiver of retrocessions clause is effective even when it does not mention an order of magnitude of the expected retrocessions.

In the case of investment advice, the client makes the investment decisions. This makes it difficult for the financial service provider to estimate the order of magnitude of retrocessions in relation to the portfolio value. However, the issues at stake are slightly different depending on whether we are dealing with so-called portfolio-based investment advice (i.e. investment advice taking account of the client portfolio) or transaction-based advice. That said, in both cases the financial service provider is not in a position to estimate the retrocessions to be received since the provider does not know, or does not know with sufficient certainty, what investments will be made by the client. The Supreme Court has not ruled on the validity of the waiver in the context of the advisory mandate; it seems likely that it will not require an order of magnitude for transaction-based advice, in keeping with what it has decided for execution-only relationships.

The Supreme Court will have to take account of the state of the law at the time of its ruling. In the meantime, it could draw on the FINMA circular on the rules of conduct under the FinSA, currently published in draft form and due to come into force in 2025. This text stipulates that the service provider must communicate to the client "(i) a range of remuneration taking into account the different categories of products; (ii) additional information on the range of remuneration depending on the value of the portfolio and the agreed investment strategy. **The above applies to portfolio management and portfolio-based investment advice" (emphasis added)**.

For example, in the case of portfolio-based advice (as opposed to transaction-based advice), FINMA considers that the financial service provider must provide the client with an order of magnitude of the expected retrocessions. This requirement may seem excessive given the difficulty of making such an estimate.

In conclusion, following the Supreme Court's ruling of 24 May 2024, it has been established that an execution-only client can validly waive retrocessions only if the client is informed of the parameters for calculating retrocessions (ranges per type of product). With regard to investment advice, the situation is somewhat delicate: it appears that the respective Supreme Court and FINMA views are not yet aligned. From a prudential point of view, FINMA will probably succeed in imposing disclosure of an order of magnitude for retrocessions in a portfolio-based advisory mandate. For independent asset managers, it is therefore prudent to implement this rule now and to communicate to clients under a portfolio-based advisory mandate an order of magnitude of retrocessions, i.e. a range of expected retrocessions over the year, in relation to the value of the portfolio.

This communication (based on regulatory law) will also make it possible to ensure that the client has validly waived retrocessions (from the point of view of civil law).

Calculating the expected retrocessions in a portfolio-based advisory mandate is not a simple exercise, for the calculation is based on the assumption that the client will follow all the advice given. Taking into account the agreed strategy and the value of the portfolio, an estimate (which may not always be accurate) can be made of the expected retrocessions.

Biography

Frederique Bensahel is a partner in the FBT law firm and head of its Banking & Finance team. She has been advising financial institutions for over 30 years. Her practice covers financial regulation and extends to civil and regulatory financial litigation, internal investigations and enforcement proceedings.