Do Financial Service Provider need to reimburse Kickbacks to their Clients?

Recent Developments in Switzerland

1. Introduction

In a nutshell, there are at least three different types of contractual relationships between the financial service provider and the client: Asset management, investment consulting and a pure account/depot-relationship (execution only).[1] Contrary to the investment consulting and the execution only relationship, in the asset management relationship the asset manager specifies the investment strategy of assets within his own discretion according to the individually agreed investment structure.[2]

In October 2012 the Swiss Federal Supreme Court ordered a Swiss bank to reimburse kickbacks to its client with retroactive effect. This judgement made clear that clients with an asset management agreement are entitled to all commissions and/or retrocessions that financial service providers receive from third parties.[3]

The following article addresses the controversial issue if financial service providers are obliged to surrender their kickbacks, retrocessions, distribution fees and all other commissions and monetary benefits to their clients which they received in connection with their contractual relationship with them.

2. Asset Management Agreements

2.1 Obligation to disclose Information

Asset management agreements are governed by the rights and duties related to law of mandates (articles 394 et seq of the Swiss Code of Obligations (CO)). According Article 400 para. 1 CO the asset manager - as an agent - is obliged to disclose to the principal any and all information regarding its mandate at any time at the principal's request.

Subject to such accountability is everything that is connected to the mandate in the name of the principal, even internal documents such as notes, drafts or other records. Disclosure by the agent has to be made even if the compilation of the required files involves great

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[1] Cf *Thalmann* in Festschrift für Jean Nicolas Druey, Von der vorvertraglichen Aufklärungspflicht der Bank zur börsengesetzlichen Informationspflicht des Effektenhändlers, p 974 et seq.
[2] Federal Supreme Court of Switzerland, judgment of 4 January 2007 (BGE) 133 III 97 E 7.1, p 102.
[3] Federal Supreme Court of Switzerland, judgment of 30 October 2012 (BGE) 4A_127/2012, 4A_141/2012.

expenditure.[4] The mere report of a lump sum, which makes it impossible to determine the composition of the kickbacks, is not transparent enough and consequently cannot be sufficient in terms of accountability pursuant to Art. 400 para. 1 CO.[5]

In this context it is important to note that the obligation of accountability exists irrespective of the fact whether or not kickbacks have to be surrendered. Even if asset managers argue that kickbacks – for whichever reasons – shall not be surrendered to the principal, they must nonetheless deliver a report on the receipt of kickbacks.

Not providing full transparency can also have criminal consequences: Based on a judgement of August 2018 of the Federal Supreme Court of Switzerland, an asset manager has been convicted of criminal mismanagement because he has concealed from his client that he has received retrocessions and remunerations from a bank.[6]

2.2 Obligation to surrender Kickbacks

The Federal Supreme Court of Switzerland found in a landmark decision in 2006 that kickbacks distributed to external asset managers belong to the client and therefore have to be forwarded and reimbursed to them. Retrocessions must be returned to the client because of the internal connection with the contractual relationship.[7] In 2011 the same court stated that the obligation to surrender the kickbacks is a core element of the external utility of the mandate and that it constitutes a preventive measure to safeguard the interests of the principal.[8]

Apart from a mandatary's fees, the mandatary shall neither bear profit nor loss from the mandate agreement. Consequently, all assets received by the asset manager from third parties, which can be linked to the mandate agreement, must be forwarded to the principal. The asset manager may only keep contributions which were received from a third party during the execution of the mandate agreement if such contributions cannot be linked to the agreement.

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[4] Federal Supreme Court of Switzerland, judgment of 9 November 2012 (BGE) 139 III 49, E 4.1.3 p. 54, E. 4.4.2. p. 58.

[5] cp decision of the commercial court of Zurich dated 26 June 2007 ZR 107/208, p 129, 132: „ […] the principal [must] be wholly and truthfully informed about the arising kickbacks […]" *Fellmann*, Berner Kommentar, recitals 20, 27, 35, 58.

[6] Federal Supreme Court of Switzerland, judgment of 14 August 2018 (BGE) 6B_689/2016.

[7] Federal Supreme Court of Switzerland, judgment 22 March 2006 (BGE) 132 III 460 E 4.1.

[8] Federal Supreme Court of Switzerland, judgment of 29 August 2011 (BGE) 137 III 393 E 2.3 p. 397.

Therefore, a financial service provider must forward to the client all monetary and non-monetary advantages received from third parties as part of the performance of the contract. Keeping additional earnings violate the principle of non-enrichment.

To sum up, in the case of asset management agreements, there is an unquestionable obligation to surrender kickbacks to the client received by third parties.

2.3 Conflict of Interests

One of the fundamental problems regarding kickbacks lies in the potential conflict of interest. As an agent, an asset manager may represent only the interests of the client towards the other financial service providers. However, in case the asset manager receives contributions of these third parties, the risk remains that the interests of the client may no longer be represented properly. If in addition to it, the asset manager withholds kickbacks for its own benefit and refrains from transferring them to the entitled principal, it can be held liable by the principal for violation of the mandate agreement (Art. 400 para. 1 CO).

In its judgement of 2012, the Federal Supreme Court found that the obligation to surrender kickbacks depends also on a conflict of interest. Consequently, in the case of an asset management relationship or – under certain circumstances - investment consulting relationship, the monetary benefits received have to be passed on to the principal.[9]

3. Execution – Only Relationship

3.1 Lack of Conflict of Interest

In a pure account/depot-relationship (execution only) the client holds only an account with the bank. The client instructs the bank to invest the assets in certain financial products or to carry out certain transactions. The bank does not act as an advisor, but is only responsible for processing the transaction. Therefore, the individual investment decision is based exclusively on the client's initiative without recommendation or advice from the bank.[10]

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[9] Federal Supreme Court of Switzerland, judgment of 30 October 2012 (BGE) 4A_127/2012, 4A_141/2012.

[10] *Heim/Schenker/Pfiffner/Hammer*, Suitability & Appropriateness, Gesetzliche Übersicht für Bankfachleute und Juristen, p. 67; *Trautmann/Von der Crone*, Die Know-Your-Customer Rule im Vermögensverwaltungsauftrag, p. 136 et seq; *Jentsch/Von der Crone*, Informationspflichten der Bank bei der Vermögensverwaltung, SZW 2011, p. 639; *Gutzwiller*, Rechtsfragen der Vermögensverwaltung, p. 73 et seq.

Although in its judgement of 2012, the Federal Supreme Court has made the obligation to surrender kickbacks dependent on a conflict of interest, literature and established case-law disagree with this narrow interpretation. They state that the obligation to surrender is dependent on an "inner connection" between the execution of an order and the pecuniary benefit. In addition to it, the external utility of the order, the principle of non-enrichment and a lack of (equivalent) distribution costs have to be considered. Therefore, the criteria of a conflict of interest is only one of several possible criteria on the basis of which an internal connection can be affirmed.[11]

3.2 Obligation to surrender Kickbacks

In a judgment in 2012, the Federal Supreme Court affirmed the obligation to surrender kickbacks in a pure execution-only relationship. The court did not make the existence of a conflict of interest as a mandatory precondition for an obligation to surrender. There was neither an asset management agreement, nor an investment advice agreement part of this judgement. Nevertheless, the financial service provider had to reimburse the benefits received from third parties to the client.[12] Recently, the legal opinion that the reimbursement of kickbacks to the client does not necessarily presuppose a conflict of interest between the financial service provider and the third party was confirmed as "*obiter dictum*" by the Commercial Court of Canton of Zurich in 2017.[13]

According to the tendency of the Swiss courts and the prevailing doctrine focusing on the pure principles of mandate law, the obligation to surrender kickbacks - also in an execution-only relationship – will most likely become the standard.

4. Waiver of Claims regarding Kickbacks

A waiver about surrendering kickbacks has to ensure that the principal has been transparently informed about potential kickbacks. As long as the principal is aware of the calculation basis, the potential range of the kickbacks and it agrees in full knowledge of the inherent interest of conflict relating to this type of asset management model, the prerequisites of the altruistic

[11] *Jean-Marc Schaller*, Retrozessionen: Herausgabepflicht auch bei „Execution-Only", www.finblog.ch (blogpost 10/170220).
[12] *Jean-Marc Schaller*, Retrozessionen: Herausgabepflicht auch bei „Execution-Only", www.finblog.ch (blogpost 10/170220).
[13] Commercial court of Zurich, decision of 15 November 2017, HG 150054.

nature of the mandate agreement are met. Therefore, the principal has to be informed, if and to what extent the agent`s acts might be influenced by agreements with third parties.[14]

It has to be determined on a case-by-case basis if the prerequisites for an effective waiver of kickbacks have been met. It also has to be taken into account whether or not the principal is well versed in this kind of financial business.[15]

In court proceedings, the burden of proof lies with the agent when it comes to the matter whether it has compiled with its information obligation or reporting requirements and consequently, whether or not the waiver has been agreed upon in a legally binding way. Regarding General Terms and Conditions in Switzerland, in 2007 Emmenegger already correctly advocated that: “A legally binding and valid waiver of the handover obligation is only possible if the waiver is made in a separate declaration. However, this means that the waiver is no longer part of the general terms and conditions (T&Cs). In conclusion, a valid waiver regarding the obligation to surrender cannot be agreed upon in the T&Cs.”[16]

Since 2007, the Swiss banks continuously improved their contractual basis and T&Cs to comply with the new jurisdiction in order to obtain a legally valid waiver from the client. However, as it has to be determined on a case-by-case basis, there are still many cases in which the clients have *legally* not waived their claims which makes it still possible for them to sue the banks for the kickbacks. Experience shows that valid waivers were provided to clients only in late 2012 or later.

5. Prescription of Claims based on Kickbacks according to Swiss Law

In its decision of 16 June 2017, the Swiss Federal Supreme Court held that the obligation to account for and pass on retrocessions to the client under the law on mandates is subject to a ten year statute of limitation starting as of the receipt of the retrocessions by the agent.[17]

The main reason for this decision was that the legal basis for surrendering kickbacks does not constitute a pure periodic obligation to perform. The mandatary is not obliged to surrender

[14] Federal Supreme Court of Switzerland, judgment of 29 August 2011 (BGE) 137 III 393, E 2.4, p. 398; *Nänni/Von der Crone*, Rückvergütungen im Recht der unabhängigen Vermögensverwaltung, SZW 2006, p. 383.
[15] Von *Büren/Walter*, Die wirtschaftliche Rechtsprechung des Bundesgerichts im Jahr 2006, ZBJV 143/2007, p. 449 et seq.
[16] *Emmenegger* in Anlagerecht, Anlagekosten: Retrozessionen im Lichte der bundesgerichtlichen Rechtsprechung, 2007, p. 86.
[17] Federal Supreme Court of Switzerland, judgment of 16 June 2017 (BGE) 4A_508/2016.

yields periodically to the principal. The nature and extent of the surrender claim depends on when the principal requests the agent to surrender the accrued revenues. Furthermore, the surrender claims are linked to an ancillary duty for which the same prescription period applies as for the main duty (cf. Art. 133 CO). The main obligation in such cases is the proper asset management, for which the ten-year prescription period applies in accordance with Art. 127 CO.[18]

Furthermore, the Swiss Federal Supreme Court held that the agent's obligation to surrender retrocessions to the principal is due on the date of receipt of each individual retrocession by the agent irrespective of when the principal becomes aware of the claim and of its maturity.

6. Conclusio

In order to verify a claim regarding kickbacks, the transparent report on the receipt of kickbacks given by the financial service providers is needed. In this case it is irrelevant whether the contractual basis between the financial service provider and the client was based on an asset management-, investment consulting-, or a pure account/depot-relationship (execution only). The obligation of accountability exists irrespective of the fact whether or not kickbacks have to be surrendered according to Art. 400 Abs. 1 CO.

Based on the tendency of current Swiss case law and doctrine, kickbacks have to be surrendered not only based on a conflict of interest. Only an inner connection between the kickback received and the relevant contractual relationship (incl. execution-only) will be a sufficient legal basis to claim back retrocessions.

[18] *Schaller*, Retrozessionen, Nochmals zur Verjährungsfrage, in: Jusletter, dated December 3, 2012, recital 3 et seq.