

Treatment of retrocessions and other third-party payments under FinSA

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Introduction

The new Financial Services Act (FinSA) has introduced a number of regulatory obligations for financial service providers towards their clients. While the former Swiss regulatory framework did not deal with this question, but instead relied entirely on case law of the Federal Supreme Court, FinSA and its ordinance mention retrocessions in several provisions. In particular, the new act contains a section entirely dedicated to the prevention and handling of conflicts of interest, dealing among other things with retrocessions and similar benefits received by financial service providers from third parties (Article 26 of FinSA). Moreover, while Article 17 of FinSA establishes the general principle of good faith in the processing of client orders, Article 18 of FinSA requires financial service providers to ensure that their services achieve the best possible results for their clients. From a financial point of view, not only the price of the financial instrument, but also the costs incurred by the execution of the order and any compensation received by the financial service provider from third parties, such as retrocessions, must be taken into account.

Even though statutory provisions did not deal with the problem, the permissibility of retrocessions in the field of financial services was a hot topic long before the introduction of FinSA, because of the potential conflict between the interests of firms and clients deriving therefrom. The acceptance of such third-party compensation is now governed by Article 26 of FinSA. Specifically, these payments must be passed on completely to the client, unless the latter, having all of the relevant information, willingly gives up their entitlement to such benefits. As for many other rules, under Article 26 of FinSA there is an interim regime valid for up to two years: the new regulatory requirements will become applicable in their entirety on 1 January 2022.

Retrocessions and other third-party payments according to FinSA

Article 26 of FinSA covers all types of compensation which financial service providers receive from a third party in connection with the provision of financial services to clients. By way of example, the provision mentions brokerage fees, commissions, kickbacks and rebates and other financial benefits. The type of financial service at issue is irrelevant. Thus, compensation within the scope of portfolio management mandates, investment advice relationships or the mere execution of transactions with financial instruments are covered. In contrast, services which enable the provision of financial services in the first place or which are necessary for it, such as custody fees, settlement and exchange fees, management fees or statutory fees, and which meet the organisational requirements of Article 25 of FinSA, do not constitute compensation in the sense of Article 26 of FinSA. The term 'third parties' also refers to the companies of the group to which the financial service provider may belong.

Compensation according to Article 26 of FinSA should not be confused with the remuneration of the financial service provider's employees. Further, financial service providers are subject to certain organisational requirements (see Article 25 of FinSA). In particular, they must structure their employee compensation schemes to avoid conflicts of interest.

Permissibility: conditions

Not all conduct obligations introduced by FinSA are entirely new. Many of the new regulatory requirements already existed, even if only from a civil law perspective and, in most cases, in

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significantly less-detailed terms. Further, Federal Supreme Court case law, with its interpretation of the former regulatory requirements and the relevant contract law provisions, offers some guidance and the basic principles underlying FinSA's provisions on retrocessions were developed in this context. As mentioned in the introduction, the permissibility of such third-party payments had already been the object of lengthy debate; however, in the absence of regulation on this matter, it was left to the courts to provide some guidance. Based on the contract law provisions on the mandate, more specifically on Article 400 of the Swiss Code of Obligations, which requires agents to account for their management at any time on request and to reimburse to the principal everything that they have received through the provision of the service, the Federal Supreme Court developed the following rule, which has now been codified by FinSA. Financial service providers may accept compensation from third parties only if they:

- pass it on to their clients in full; or
- expressly inform the clients of the compensation in advance and the clients waive their right to such compensation.

In the event that a certain kind of compensation, by its nature, cannot be passed on to the client, it must be disclosed, as it constitutes a conflict of interest. This refers to the so-called 'non-monetary compensation elements' (eg, when the third party (which is often another financial service provider) provides the financial service provider with market and financial analyses (so-called research) or grants them access to platforms).

The client is deemed to be sufficiently informed of Article 26 of FinSA's aim if it is aware of the existence, nature and extent of the compensation before the relevant contract is concluded or the service is provided. If the amount of compensation cannot be determined in advance, the client must be informed about the applicable calculation parameters and, as soon as the exact amount has been determined, the financial service provider must disclose such amount to the client. Even if the right to the compensation has been validly waived, the financial service provider must still provide the client, on request, with information on the compensation effectively granted or received in connection with financial services for this client.

Treatment of retrocessions under MiFID II and FinSA

While FinSA, taking into account Federal Supreme Court case law, allows the receipt and retention of retrocessions under certain conditions, the requirements under the EU Markets in Financial Instruments Directive (2014/65/EU) (MiFID II) are somewhat stricter. In fact, retrocessions under portfolio management agreements and investment advisory agreements with independent investment advisers in the European Union are generally prohibited (Article 24 of the MiFID II and Article 12 of the EU Delegated Regulation (2017/565) supplementing MiFID II). The only exception regards minor non-monetary benefits that are capable of enhancing the quality of the service provided and are of a scale and nature such that they could not impair compliance with the financial service provider's duty to act in the best interest of its client. This type of compensation must also be disclosed to the client. However, it would be extremely difficult for financial service providers to produce the proof of evidence for the 'quality-enhancing' character of a particular benefit. Thus, the withholding of retrocessions by portfolio managers and investment advisers under EU law seems virtually impossible. Nevertheless, in the context of other financial services, the conditions of MiFID II for the acceptance of compensation from third parties correspond in part to FinSA's approach, in that compensation is permitted if it is passed on to the client or, in some cases, on disclosure and waiver of the client (Article 11 of the EU Delegated Regulation supplementing MiFID II).

The background of the prohibition on the acceptance of third-party payments in the context of portfolio management is primarily the structural control problem in portfolio management relationships, while the prohibition relating to independent investment advice services was intended to create a marketing label for investment advice free of conflicts of interest. The more liberal approach of FinSA, which is based on the duty of disclosure, does not regulate the control problem in portfolio management relationships. However, this was deliberately taken into account in the legislative process: client protection in Switzerland should not be achieved by a general or partial ban, as is the case in the European Union, but through comprehensive transparency regarding the compensation received from third parties. The legislature considered that, with all the necessary information, clients are able to decide themselves, whether the withholding of the disclosed third-party payments by the service provider is acceptable to them or not. This moderate difference may constitute an interesting regulatory location advantage or disadvantage – depending on the perspective for portfolio managers and independent investment advisers operating in Switzerland on the one hand and clients on the other.

Comment

Retrocessions and similar benefits received by financial service providers from third parties bear a

significant risk of conflicts of interest. Besides establishing the general principle of good faith in the processing of client orders and requiring best execution, the new FinSA addresses for the first time on a statutory level the permissibility of retrocessions from a regulatory point of view. The relevant rules codified the existing case law of the Federal Supreme Court on Article 400 of the Swiss Code of Obligations regarding the mandate. Consequently, third-party payments in Switzerland are allowed as long as certain conditions are met. The key element under FinSA is transparency. By contrast, the European Union adopted a much stricter approach: by prohibiting retrocessions in the context of portfolio management and investment advice services, MiFID II straight-out prohibits any retention of retrocessions. An exception is possible only where the retrocessions in question are of non-monetary nature and insignificant or service quality improving. However, it would be rather difficult for financial service providers to produce the necessary evidence. The more liberal approach of Article 26 of FinSA thus reflects the principle of freedom of contract while creating a level playing field between clients and portfolio managers as well as independent investment advisers in Switzerland.

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