

External asset managers under increased scrutiny

Switzerland is levelling the financial sector's playing field by assessing the lack of regulation regarding external asset managers. Daniel Stoll and Nicolas Schwarz Thouvenin Rechtsanwälte outline the changes

When people think of Switzerland they think of chocolate, cheese and banks. And indeed the financial sector is one of the pillars of the Swiss economy. Switzerland is widely considered a safe haven, with stable political and economic conditions, and an efficient infrastructure, and is one of the world's preferred financial centres. In 2000 the estimated proportion of the gross domestic product (GDP) contributed by the financial sector as a whole came to 10.9%.

A traditional strength of the Swiss financial centre is asset management, which at the beginning of the new millennium made up over half of the banks' total added value. In this business domain Switzerland holds a leading global position. In recent years, the value of assets managed in customer accounts in national banks amounted to SFr3,000 to SFr4,000 billion (\$2,486 to \$3,314). Foreign customers accounted for more than 50%. Of all assets held, more than 40% came from private clients.

Eight percent to 10% of all assets, that is, SFr300 billion to SFr400 billion, are managed by external asset managers (EAMs). According to an assessment by the Association of Swiss Asset Managers, there are 2,000 to 2,500 EAMs employing up to 7,000 people in Switzerland. So external asset managers are key players both for banks and for clients.

Minimal state regulations for external asset managers

EAMs act as independent enterprises and manage customers' assets as professionals without forming part of a bank. The 1990s offered private bankers that had strong ties to customers a good environment to open up their own businesses as EAMs. So EAMs are often boutique firms employing seasoned bankers, and other specialized professionals such as lawyers or trust officers. External asset

managers advise their customers in the management and investment of funds; in particular they provide portfolio management services against payment of a fee. In this limited business field they offer the same services as banks and brokers.

Whereas securities dealers are governed by the Federal Act on Stock Exchange and Securities Trading (Sesta) and banks are regulated both by the Swiss Banking Act (SBA) and the Sesta, external asset managers are not subject to strict market regulation, with the exception of the legislation to combat money laundering. As with banks and securities dealers, EAMs qualify as financial intermediaries and are, in this capacity, subject to the Money Laundering Act (MLA), which came into force in 1998 and imposes a comprehensive framework legislation concerning obligations of due diligence on financial intermediaries, such as the identification of the customer and the beneficial owner.

Apart from that, state regulatory frameworks are largely missing. As a consequence of this loose regulation, some claim that specific provisions, such as Art 11 Sesta, apply to EAM indirectly, that is, by analogy. Article 11 Sesta defines specific duties to be complied with by the financial services provider. These duties include the obligation to disclose to clients the risks associated with certain types of transactions, the duty of diligence by ensuring the best execution of the clients' orders and that orders are retraceable, and, last but not least, the obligation of loyalty by ensuring that in any potential conflict of interests the client's interests are not

adversely affected. Although some courts by now have applied Article 11 Sesta to the EAM analogously, the applicability remains disputed.

Against this background, it is obvious that EAMs, in comparison with their competitors (banks and securities dealers), must only comply with a minimum of regulations. In particular, until today, EAMs have not been monitored by a government watchdog, and the self-regulatory professional association of the EAMs has no strong means of sanctioning misbehaving members. It comes as no surprise that experts, among them the IMF under its Financial System Stability Assessments, think that the EAMs profit from unjustified competition advantages and should be subjected to prudential supervision.

As a consequence of these critical voices, the Swiss government appointed an expert commission (Group Zufferey) to render a report, which was presented in November 2001. The experts recommended that EAMs be subject to a comprehensive supervisory body. A further group of experts (Group Zimmerli) was commissioned to set out a report

and to draft a bill for the organization of the Federal Financial Market Supervision. In February 2005, Group Zimmerli submitted its report on the prudential supervision of EAMs, introducing brokers, and foreign exchange traders.

The experts say that a differentiated approach should be taken, and that, before a bill should be drafted, the Federal Council should take a fundamental decision whether or not to subject all financial intermediaries to state supervision or whether, alternatively, self-regulatory bodies should be put in place. According to the experts, a need for immediate regulatory action was spotted only with respect to the supervision of asset managers of foreign collective investments. Thus it will take some time before state monitoring of EAMs will become law, if at all, but asset managers of foreign collective funds might become subject to monitoring soon.

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Contractual aspects of the EAM business

Many banks have substantial business with external asset managers and maintain special business units for that purpose. Services formerly provided by the banks are now performed by the EAMs. So it is important to understand the main differences between a traditional bank/customer relationship and the situation where the customer has appointed an EAM. On first sight the following principles apply to EAM customers:

The EAM, not the bank, is responsible for the definition of the investment strategy and the portfolio management.

The customer relationship management is in the hands of the EAM, so the bank plays a passive, mainly administrative role and has no direct contact with the customer. The banks even delegate compliance matters, for example, customer identification, to the EAM.

The relationships between the EAM, the customer and the bank form a triangle (see box 1).

Given this triangular contractual relationship, customers sometimes have difficulties in deciding who to address in specific situations, in particular when it comes to disputes about losses. The following explanations will shed some light on the rights and obligations of the par-

ties involved.

External asset manager/customer: portfolio management contract

The legal relationship between the EAM and its customer is normally governed by a portfolio management agreement, which usually contains detailed rules on the portfolio strategy, the reference currency and the fee structure. In regard to fees the concepts vary between pure flat-fee arrangements and fully performance-oriented fee schedules. A large number of EAMs use as a role model for their contracts the Guidelines of the Swiss Federal Banking

Commission for Asset Management Contracts and/or the standards of the Swiss Association of Asset Managers. The Swiss Association of Asset Managers advises to put in writing specific customer instructions that do not fall into the normal scope of asset management, for example, the right to take loans, to make derivative investments other than for hedging purposes or the right to charge fees to the account directly.

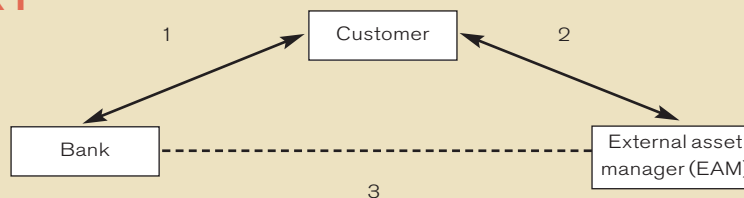
Portfolio management contracts are interpreted pursuant to the provisions of the Swiss Code of Obligations (CO) on mandates. A number of EAMs joined the Swiss Association of Asset Managers. The Association has published Rules of Conduct to be adhered to by its members. A violation of the Rules of Conduct could result in the exclusion of the misbehaving member. But the Rules of Conduct not only apply to members, the courts also referred to them as an industry standard. By referring to the Rules of Conduct, the courts have developed extensive case law on the EAMs' duty of diligence, duty to disclose the risks involved with specific transactions and duty to avoid conflicts of interest.

External asset manager/bank: retrocession payments

To keep administrative efforts low, EAMs regularly concentrate on a few banks that take the role of custodian and provide the administrative platform for the customers' assets.

In principle, no formal agreements are required to define the relationship between EAMs and banks. The EAM derives its rights to act *vis à vis* the bank from a power of attorney given by the customer empowering the EAM to manage the funds. Due to developments in recent years, the banks and the EAMs

Box 1



- 1) Custodian/administration contract between customer and bank.
- 2) Portfolio management mandate between customer and EAM, including a power of attorney in favour of the EAM *vis à vis* the bank, to manage the funds.
- 3) Based on a (limited) power of attorney, the EAM is representing the customer *vis à vis* the bank. There are no specific contractual agreements between the EAM and the bank, except framework agreements.

have, however, started to regulate their legal relationship in framework agreements, usually pertaining to all customers of the EAM that have an account with the respective bank.

As a rule, the more assets placed by the EAM's customers with the bank, the more favourable the conditions become under the framework agreement.

In the framework agreement, the bank requires from the EAM confirmations relating to compliance matters in the combat against money laundering; in this context the banks often delegate the duty to identify the customer to the EAM.

Further, the framework agreement sets out the EAM's obligation to adhere to specific investment principles and to inform customers of any risks associated with the investments. Framework agreements also regularly foresee that the

bank will not be liable for the quality of the services provided by the EAM and the performance of the investments.

Under the framework agreement, the banks undertake to keep e-banking platforms and research tools at the EAM's disposal. Furthermore, different models of compensation for the EAM's services will be found. Because work formerly done by the banks is now outsourced to the EAMs,

some banks share commissions earned with trades on the customers account with the EAM. This type of compensation is referred to as *retrocession* or *soft money*. Some say that retrocession payments create conflicts of interests between the EAM and the customer. For example, a conflict of interest would arise if the EAM were making unnecessary transactions to increase its own revenues. To avoid such situations, some

banks have started to eliminate retrocession payments and, instead, directly reduce commission rates. Whether this will result in lower costs for the customers remains to be seen. In the absence of retrocession payments, the EAM will probably increase the fees payable under the portfolio management contract. Today, it is widely accepted that, for the sake of transparency, the EAM should disclose to the customer that the bank might pay a retrocession. Failure of disclosure might result in the customer claiming a refund.

Customer/bank – direct contacts rare

The customer maintains the account and the portfolio with the bank so has to sign all pertaining account opening forms and agreements. However, once the account is opened, and sometimes not even at the occasion of account opening, the customers often have no direct contact with the bank, because the bulk of the account and portfolio handling is performed by the EAM. The bank is also reluctant in approaching the customer directly; it rather communicates with the customer through the EAM.

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To enable the EAM to become active and to perform under the portfolio management agreement, the customer provides the EAM with a power of attorney to represent it towards the bank. Of course, the power of attorney is mostly limited to investment instructions; normally, withdrawals and certain derivatives as well as OTC transactions are disallowed.

Losses and liabilities

As long as the portfolio is doing well and the EAM is making money for its customers, liability is a non-issue. But if the portfolio is generating losses, customers often want to know whether they can hold anybody liable.

The EAM's liability

The Swiss Federal Supreme Court sets high standards of diligence to be observed by the EAMs. Court decisions often make reference to the respective guidelines of the Swiss Federal Banking Association and the Association of Swiss Asset Managers.

The EAM must ensure that the investment strategy suits the customer's needs.

Before defining the investment strategy, the EAM must familiarize itself with the customer's financial situation (the know-your-client rule), and the risk profile and suitable strategy should be defined based on this analysis. If the

customer wants an investment strategy that is not in line with its risk profile, the EAM, to avoid liability, must advise the customer accordingly. The courts have even affirmed liability when the EAM correctly informed on the risks of an investment but, at the same time, had pretended unrealistic profits. If the EAM defines an inadequate strategy and losses occur, the EAM will, certainly in cases of gross negligence, become liable.

Of course, the EAM must adhere to the investment profile set out in the portfolio management agreement. Deviations from the contract, combined with losses, form the grounds for liability claims. The EAM should also ensure that the customer is continuously

informed. It might become liable if it fails to do so, because a lack of information deprives customers of the chance to cut their losses.

The bank's liability

As set out above, the bank merely provides the administrative platform for the banking transactions. Therefore, as a general rule, the bank is only liable for the diligent execution of the transactions and the proper processing and functioning of the deposit and account. Nevertheless, quite often the banks become the targets of liability claims by customers that have suffered damages. One of the more obvious reasons is the solid solvency (deep pockets) of banks, as opposed to the meagre capitalization of the EAMs and their lack of professional liability insurance.

The bank must not allow the EAM to exceed the scope of the investment power of attorney communicated to the bank. If the power of attorney is exceeded and losses occur, the bank will be jointly liable with the EAM. If the EAM exceeds the power of attorney without the bank knowing, the bank cannot be

held liable. In other words, the bank has no obligation to monitor the EAM. The bank is also not necessarily obligated to interfere if the EAM transacts business of which the customer's economical benefit is doubtful. But in this context many

questions are controversial and, depending on specific surrounding circumstances, the bank could find itself in a minefield, in particular if it becomes a question whether the bank acted in good or bad faith.

Under aspects of liability it might also become problematic for banks if they do not maintain enough organizational and economical distance from the EAM. In such instances, the customers might claim that they considered the bank and the EAM as a unity. In particular, the EAM might be deemed as an assistant of the bank if it shared offices with the bank, if the EAM met with the customers in the bank's meeting rooms or if there were another economical interweaving that made the EAM appear as

not sufficiently independent from the bank. Banks are well advised if they draw – for everybody – a line between their and the external asset manager's organization and administration.

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