Churning: practical guidelines for portfolio managers

Churning has been in the news following a ruling in a criminal case rendered by the Swiss Supreme Court in 2024. In this ruling, our High Court established objective criteria for determining the existence of churning. Churning occurs when a portfolio manager reinvests the assets entrusted to him by his client too frequently, motivated by his variable remuneration rather than the client's interests. It is contrary to the manager's duties towards his client and constitutes the criminal offence of disloyal management. Such practice may also give rise to civil and regulatory liability on the part of the manager.

Frédérique Bensahel,
Partner, FBT Avocats SA

Aurélie Moyal-Azra,
Associate, FBT Avocats SA

Determining whether churning is taking place is not straightforward. While older case law provided general guidance, the 2024 ruling represented a step forward. Drawing on criteria from US case law, the Swiss Supreme Court identified three **objective indicators** for assessing whether a certain behaviour constitutes churning.

a) Turn-Over-Rate (TOR)

This index measures the frequency of transactions in relation to assets under management and is determined by dividing the total value of transactions by the average value of the portfolio over the same period, generally one year. Case law has focused on conservative investment strategies to determine the rates, specifying that speculative investment strategies may justify higher rates:

- an annualised TOR of 2 may raise doubts as to the existence of churning;
- an annualised TOR of 4 suggests churning activity; and
- an annualised TOR of 6 may be considered as conclusive in terms of churning.

b) Cost-to-Equity Ratio (or break-even ratio)

This index represents the ratio between the annual management cost and the average net asset value. It is calculated by dividing the total portfolio-related costs by the average net

asset value. It indicates the minimum return required to cover management costs and generate a profit (break-even point). The rates defined by case law relate to conservative investment strategies, with higher ratios being permissible in the case of speculative investment strategies:

- a ratio of 4 may be a warning sign of the existence of churning;
- a ratio of 8 suggests churning; and
- a ratio of 12 may be considered as strong evidence of churning.

c) Commission-to-Equity Ratio

This is a peripheral index used in the case of forward transactions. It compares the cost to the average equity consumed over the entire trading period and is calculated by adding up the total transaction costs and dividing them by the average equity consumed. The maximum threshold of 11.8% is used as an indicative limit; above this threshold, churning should be considered to exist.

The 2024 case law provides portfolio managers with benchmarks for monitoring their activity and avoiding churning. It serves two purposes:

- **Preventing legal risk**: the indices allow managers to refer to objective elements that are relatively simple to calculate in order to verify that their activity does not constitute churning;
- **Managing client interests**: the indices make it possible to ensure the relevance of transactions and management carried out. Managers can thus determine whether management is appropriate for the costs it incurs and adjust the remuneration model applied when costs absorb an excessive share of performance.

However, the indices developed by case law have their limitations. First, the nature of the mandate binding the manager to his client and the investment strategy agreed with the client may influence the frequency of transactions. Nevertheless, the values defined for each ratio were set within the framework of a conservative investment strategy and are not applicable to other investment strategies. Secondly, the authority retains a certain degree of discretion, as case law specifies that these are only indicators that may lead to a conclusion of churning depending on the specific circumstances of the case.

Despite these limitations, these developments in case law are important because churning exposes portfolio managers to potential civil, regulatory and criminal liability:

- In civil law, churning may constitute a breach of the manager's obligations, particularly from the perspective of conflict of interests.
- From a regulatory perspective, churning contravenes Article 27(a) of the Financial Services Ordinance, which refers to behaviour that consists of "restructuring client deposits without the clients having an economic interest in doing so".
- In criminal law, churning may constitute the offence of disloyal management because the manager, who is required to protect the client's interests, is harming them for his own benefit. Case law considers that even when excessive trading is justified, for example due to market volatility, the offence may still have been committed, since it is the manager's responsibility to adapt his remuneration system to market conditions.

It therefore seems important that monitoring key indicators, namely the Turn-Over-Rate and the Cost-to-Equity Ratio, should now be an integral part of risk management process. If the threshold rates are in danger of being reached, prudence dictates that managers should seek

their client's agreement or adapt their remuneration model in order to guarantee the possibility of performance despite the costs.

Biographies

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.

Aurélie Moyal-Azra is an Associate and member of FBT's Banking & Finance group. She advises Swiss and foreign banking establishments, companies active in asset management, as well as Swiss and foreign fund managers. Her experience extends to providing advice to natural and legal persons with respect to financial market legislation, to contract law or criminal business law. Aurélie Moyal-Azra also advises private clients.