CENTRE DE DROIT BANCAIRE ET FINANCIER

Banking contracts

Algorithmic trading and market making

Par Yannick Caballero Cuevas le 20 December 2021

Should the use of an algorithmic trading programme be considered a substitution within the meaning of Art. 398 para. 3 CO ? Does the agent violate his duty to inform if he does not regularly inform his principal about the progress of market making ? The Federal Supreme Court answers both questions in the negative in its judgement 4A_305/2021.

A company incorporated under Israeli law enters into a mandate agreement with a Swiss bank. Under this agreement, the bank undertakes to trade in registered shares of the mandating company on its behalf and at its risk in order to avoid an interruption in the trading of the shares. The shares are listed on the SIX Swiss Exchange. For its market making activity, the bank receives an annual fee of CHF 60,000 excluding tax. The contract begins on 1 July 2010. In an email dated 7 July 2010, the bank informs the company that it has started market making and that it is constantly monitoring the listing. It also states that the company can contact it if it has any questions. For just over eight years, there is no communication between the company and the bank. The bank issues its first invoice on 21 November 2018. The company decides not to pay it and orally terminates the contract on 20 March 2019.

When a request for payment was filed, the *Handelsgericht* of the canton of Zurich ordered the company to pay the bank's fees for the period from 1 January 2015 to 20 March 2019.

The company then lodged a civil appeal with the Federal Court. It claimed, in particular, that the bank had breached its contractual obligations by making an unauthorised substitution and by not informing it regularly of the progress of market making.

The Federal Court first of all refers to art. 398 para. 3 CO. This provision stipulates that the agent is required to execute the mandate personally, unless he is authorised to transfer it to a third party, is compelled to do so by the circumstances or if the custom allows for a substitution of powers. The Federal Court specifies that the concept of third party refers exclusively to natural or legal persons. This results in particular from art. 399 para. 3 CO, which stipulates that the principal may assert his claims directly against the third party.

In the case in question, the bank used an algorithmic programme to automate trading in order to facilitate market making. This practice consists of buying and selling a specific security with a view to improving its liquidity on the stock exchanges and thus reducing the bid-ask spread. This algorithmic programme is therefore a tool, such that it has no legal personality and cannot be considered a third party. Consequently, the use of an algorithmic trading programme does not constitute a substitution within the meaning of Art. 398 para. 3 CO.

The Federal Court then examined whether there had been a breach of the duty to inform. It stated that the contract did not provide for any obligation to draw up regular reports on the progress of market making. To this end, it relies on the cantonal ruling which indicates that the parties had contractually regulated the duty to inform. They had therefore given concrete form to art. 400 para. 1 CO. In the present case, the parties agreed that the bank would inform the company in the event of market events or activity related to the contract. In addition, the contract provided that the company would be informed ‘if necessary’. Thus, the duty to inform depended on market events or developments in the situation. However, the appellant does not explain to what extent concrete events related to the management of the mandate should have led the bank to inform it.

Therefore, the Federal Court rejects the appeal.

This ruling calls for three remarks.

Firstly, the Federal Court denies legal personality to algorithms. This is convincing, since algorithms are tools aimed at automating the execution of tasks, as in the context of algorithmic trading.

It should be recalled here that prudential obligations apply to algorithmic trading. Indeed, it can represent a risk for the markets. Art. 31 OIMF sets out obligations for both trading platforms and participants using algorithmic trading systems. FINMA Circular 2013/8 on market conduct rules also mentions algorithmic trading and requires regulated entities to ensure that their systems cannot give false or misleading signals on the supply, demand or price of securities. Furthermore, the practice of market making is permitted by the same circular.

Secondly, it is legitimate to wonder whether the Federal Court is not a little too lenient towards the bank with regard to its duty to provide information. Although no obligation to report regularly was provided for, the bank took more than eight years to send its first invoice. This was also the bank’s first communication since the email of 7 July 2010. It can be considered that the bank showed a certain degree of negligence in this regard. However, this negligence is relative. Indeed, the passive behaviour of the client company, which only contacted the bank once the first invoice had been received, can also be criticised.

Thirdly, it is not clear from the facts whether the company was informed, at the time the contract was concluded, of the use of an algorithmic trading programme. It is therefore questionable whether or not there is a duty to inform when the agent uses an algorithmic trading programme to automatically perform its service.
