Swiss asset management and fund industry facing major regulatory changes

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The Swiss asset management and fund industry will be confronted with major regulatory changes over the next two years. Although this may be seen as an unwelcome additional cost factor by some players, it is evident that Switzerland, as an important domicile for private equity and notably hedge fund managers, will benefit from the increased regulation of this business as it will allow Swiss market participants to continue to serve collective investment schemes domiciled or distributed in member countries of the European Union.

The changes to the regulatory regime concern two areas. First, the Swiss Federal Act on Collective Investment Schemes (CISA) will be amended so as to implement standards equivalent to those of the European Alternative Investment Funds Managers Directive (AIFMD) in Switzerland; this will lead to a fundamental change in so far as under the new law, asset management for any type of foreign collective investment scheme shall be subject to prudential licensing and supervision. The importance of such amendment may only be fully appreciated against the background that today, except when provided to Swiss collective investment schemes, asset management is not a regulated activity but only subject to supervision for purposes of anti-money laundering and terrorist financing prevention. In the course of the AIFMD-driven revision of the CISA, also the rules on distribution of units of collective investment schemes and the regime applicable to the custody of fund assets (see section 1 hereinafter) will be tightened. The CISA amendments are in Parliament right now and should become law in early 2013 (see hereinafter).

Secondly, already made into law by Parliament but entering into force in 2014 only, are changes to the pension fund regulation which will have the effect that in the future, subject to exemptions, only providers that are subject to financial services licensing and supervision will qualify for investment management mandates of Swiss pension schemes.

AIFMD-driven revision of Swiss collective investment schemes law

Asset management and administration of collective investment schemes

Current regulatory environment for asset managers

Swiss regulations for asset managers are still light in comparison to other jurisdictions. Asset managers generally qualify as financial intermediaries in the sense of the anti-money laundering legislation and as such must become subject to the direct supervision of the Swiss Financial Markets Supervisory Authority (FINMA) or an indirect supervision of FINMA (by becoming a member of a FINMA recognised self-regulatory organisation) for anti-money laundering purposes, however, subject to the following are not prudentially regulated.

Only in case they manage Swiss collective investment schemes, asset managers are subject to a licensing requirement and prudential supervision by FINMA. An application for voluntary supervision by FINMA is possible if, among other conditions, the asset manager shows that applicable foreign rules governing the management of foreign collective investment schemes require that the Swiss asset manager be prudentially regulated in order to be eligible for being mandated as asset manager.

Changes proposed by the Swiss Federal Council

Proposed rules regarding the regulation of asset management services

The main amendments to CISA proposed by the Swiss Government, that is, the Federal Council, regarding asset management are the following:

- asset managers domiciled in Switzerland that manage Swiss or foreign collective investment schemes and asset managers domiciled outside Switzerland that manage Swiss collective investment schemes must be prudentially supervised (in case of foreign asset managers such supervision must be equal to the one under Swiss law);
- individuals and cooperatives (*Genossenschaften*) cannot obtain a licence as a Swiss asset manager of collective investment schemes;
- Swiss domiciled asset managers must be regulated by FINMA; Swiss branches of foreign asset managers also require licensing by FINMA, which will only be granted if, in addition:

– the foreign asset manager (including its Swiss branch) is subject to rules equivalent to the rules under the CISA,
– the applicable foreign licensing requirements are equivalent to those under the new law, and
– there is an agreement in place regarding the cooperation and exchange of information between FINMA and the foreign regulator(s) supervising the foreign asset manager (and the Swiss branch);

- the Swiss Federal Council may establish a *de minimis* exemption on the ordinance level for asset managers who administer assets of not more than SFr100m or non-leveraged assets of max. SFr500m which are not subject to a right of redemption for a period of five years (all subject to the criterion that an exemption applied for must not prejudice the aim of investor protection as contemplated by the new rules); and
- FINMA is authorised to grant additional exemptions from the Swiss regulations to asset managers if (a) such exemption does not prejudice the aim of investor protection as contemplated by the new rules and if (b) the asset management was delegated to them by prudentially supervised entities (other than custodian banks) or foreign (fund management) companies which are subject to foreign rules regarding organisation and investor rights equivalent to those under the new Swiss law.

An asset manager of collective investment schemes shall be responsible for the asset management and the risk management of the relevant collective investment schemes, but may also offer other administrative services such as investment advice, asset management for individual portfolios, distribution and representative functions. In case fund management services are being offered by Swiss asset managers to foreign collective investment schemes, an agreement on cooperation and exchange of information between FINMA and the competent foreign regulator(s) must be in place (unless FINMA grants an exemption).

Proposed rules for the delegation of asset management services

Fund management companies may in principle freely delegate asset management services to other persons as long as such delegation favours a proper administration of the collective investment scheme and is ensured the proper instruction, supervision and control of the party assuming the respective tasks. However, investment decision competences shall only be delegated to asset managers that are subject to prudential supervision by FINMA or an equivalent foreign authority. Further, a delegation by a Swiss fund management company of investment decisions to a foreign asset manager is only permitted if there is an agreement regarding the cooperation and exchange of information between FINMA and the competent foreign regulator(s) (unless FINMA grants an exemption).

With respect to collective investment schemes for which a facilitated distribution in the EU is possible based on a treaty, investment decision competences shall not be delegated to the depositary bank of such collective investment schemes or to companies with interests that could conflict with the interests of the fund management company or investors.

These rules generally also apply in case of a sub-delegation of asset management services by an asset manager to another party. In all cases, the fund management company remains liable for the conduct of the mandated persons to which it delegated asset management services, as if engaged itself in such services.

Proposed transition periods

Swiss asset managers that manage foreign collective investment schemes must notify FINMA within six months after the new law will come into force and within two years thereafter, they must comply with the statutory requirements and must have submitted an application for a licence to FINMA. For the administration of EU collective investment schemes or collective investment schemes distributed into the EU, this transition period will not be of much help. In case of UCITS-compliant investment schemes, asset managers must already be prudentially regulated and for other investment schemes falling within the scope of the AIFMD, it is required that assets managers are prudentially regulated as from July 1, 2013.

Existing delegations of asset management services by Swiss fund management companies to foreign asset managers in a jurisdiction where FINMA does not have a cooperation agreement must promptly report such delegations to FINMA and must, within one year after the new law comes into force (such period can be extended by FINMA in exceptional cases), submit to FINMA declarations by the competent foreign regulatory authority wherein the latter obliges itself to cooperate and exchange information with FINMA.

New custody rules

The bill foresees certain new rules about custody of collective investment schemes. As the explanatory report states, the current rules regarding custody of collective investment schemes are of a rudimentary

nature and do not comply with current international standards. The proposed new rules did not lead to massive controversies in the preliminary discussion before the submission of the bill and in the first discussions in the Upper House of Parliament and it can be expected that the proposed rules will become effective substantially as proposed. In particular, the following changes are proposed:

Expanded obligations to have a depositary bank

Under the current rules, open collective investments schemes (contractual funds and SICAVs) must use a depositary bank. Closed collective investment schemes (SICAFs and the KGK, Limited Partnership for Collective Investment), on the other hand, did only have to appoint a custodian and a paying agent. Contrary to a depositary bank, such custodian and paying agent do not require an authorisation of the supervisory authority and have no obligation to control the activities of the other parties involved in the collective investment scheme. Under the new rules, closed collective investment schemes in the form of a SICAF always have to use a depositary bank. KGKs continue to be exempted from this obligation (as only qualified investors may invest in a KGK). In line with this new approach, even open-ended collective investment schemes (but only those in the form of a SICAV) can be exempted from using a depositary bank by FINMA under certain conditions, provided the SICAV is only open to qualified investors; provided the execution is done by prime brokers being under an equivalent supervision; and provided that the prime brokers or the competent foreign supervisory authorities supervising the prime brokers provide all information and documents to FINMA which FINMA needs for its own supervision.

More specific regulation of the tasks and obligations of depositary banks

Today, the tasks of depositary banks are only stated in rudimentary form in art. 73 CISA. Under the proposed new rules, the law states explicitly that depositary banks have to be adequately organised in view of their specific tasks as depositary banks (which will be monitored by the banking law auditors of such banks; banks need an additional licence to act as depositary banks) and that the Federal Council will issue an ordinance with more specific requirements for the activities of the depositary banks.

New rules on delegation of functions and on liability

Depositary banks are permitted to delegate the custody of the funds to third parties in Switzerland and abroad. The new rules state that such delegation may only be made provided that the delegation is in the interest of an adequate custody and provided that the third party custodians are supervised in their home countries. In case of a delegation, depositary banks are currently only liable for due care when choosing and instructing the third party custodian. The liability will now be increased significantly, as depositary banks delegating the custody will be liable for any damage caused by such third parties unless they can prove that they were acting with due care when choosing, instructing and supervising the third party custodian. Hence, Swiss depositary banks will in the future have to supervise any third party to which they delegate custody.

Possibility to introduce securities deposit insurance

The new law grants competence to the Federal Council to introduce an insurance for securities deposits, similar to the protection granted by directive 97/9/EC on investor compensation in the EU, in case a fund manager or an asset manager is not in a position to return to the investor such investors' assets. By delegating the competence to issue such rules to the Federal Council, the legislator wishes to assure that such rules will continue to be in compliance with international standards.

Offerings and distribution of units of collective investment schemes

Overview and status quo

Under current law, the criterion to determine whether a foreign collective investment scheme is subject to licensing and prudential regulation in Switzerland is whether public promotion is being made for the product or not.

- If so, the foreign collective investment scheme must be approved by FINMA (the fund prospectus and several other documents need approval of FINMA), appoint a FINMA approved Swiss representative, and may only be distributed by FINMA licensed distributors. Non-compliance with such requirements may qualify as a criminal offence.
- If no public promotion is undertaken, no financial services regulatory restrictions or requirements whatsoever need to be observed.

This will be changed fundamentally under the proposed new rules. Namely, any form of distribution of collective investment scheme will be regulated; along with this concept goes the abolition of the notion of 'public promotion'. The regulatory requirements for distribution will vary depending on the category of targeted investors.

'Distribution' as a key criterion for triggering additional licensing requirements for the offering of collective investment schemes in Switzerland

The Federal Council proposes in the bill, following the suggestions of FINMA, to abolish the term

public promotion altogether and to substitute it by 'distribution' as the new key regulatory criterion to govern the offering of collective investment schemes.

Accordingly, the proposed new law defines 'distribution' as any offering of and promotion for a collective investment scheme. Under the newly proposed rules, the purchase of collective investment schemes (a) exclusively based on the investor's own initiative; (b) under a discretionary investment management agreement (subject to this agreement and the asset manager fulfilling certain requirements); or (c) under employee participation plans structured in the form of a collective investment scheme (as often seen with employee participation plans of French companies) is not deemed to be 'distribution', subject to certain conditions.

It is evident that this new regulatory concept will lead to difficult discussions on when an interest of an investor is not 'provoked', and subject to what legal and factual features a discretionary investment management agreement or its fulfilment would have to be deemed (indirect) collective investment scheme distribution.

Distribution to qualified investors also to be further regulated

Under the new rules, any type of collective investment scheme distribution would in the future be prudentially regulated, whereby the degree of licensing requirements will depend on the category of investors to whom the collective investment scheme are distributed (into, within, or from Switzerland):

- If a collective investment scheme is promoted or sold to non-qualified investors, the situation under the proposed new rules will not substantially change compared to today's law. In particular, the collective investment scheme needs FINMA approval and must be represented by a FINMA licensed collective investment scheme representative, and it may only be distributed by a FINMA licensed distributor. In addition to these conditions, the new law requires – in adapting the similar requirement of AIFMD – that the collective investment scheme home regulator and FINMA have entered into a cooperation and information exchange agreement.
- If the promotion is limited to qualified investors as per CISA's definition of such term (see below), the collective investment scheme itself need not be approved by FINMA; however, the following new important conditions must be met:
  – a FINMA licensed collective investment scheme representative and a paying agent (*Zahlstelle*) must be appointed for the collective investment scheme; and
  – the collective investment scheme representative has to periodically review:
    (i) whether the foreign fund management company and the custodian are subject to prudential regulation (note: supervision not required) equal to the Swiss regulation in respect of organisation, investor rights and investment policy;
    (ii) whether the designation 'collective investment scheme' does provide grounds for confusion or deception; and
    (iii) whether there is a cooperation and information exchange agreement in place between the collective investment scheme' home country supervisory authority and FINMA.

In addition, if the proposal of the Swiss Government were accepted in Parliament, in the future also the distribution of collective investment schemes that are only promoted to qualified investors will trigger the requirement of a FINMA licence for the distributor (not the scheme) if the distribution is not limited to a particular category of qualified investors, namely regulated financial intermediaries and regulated insurance institutions.

It is evident that the above amendments would dramatically impact on the – until now regulatory-wise completely non-restricted – distribution of foreign collective investment schemes to qualified investors in Switzerland, and there is reason to believe that a large number of collective investment schemes from traditional off-shore domiciles may not be in a position to fulfil all of the above requirements. Hence, it does not astonish that these proposals provoked severe objection of the industry and also by members of a preparatory commission of Parliament.

More restrictive definition of 'qualified investor'

The regulation relating to the distribution of foreign collective investment schemes into, in or from Switzerland will become even more restricted due to the fact that the definition of 'qualified investor' will be tightened, resulting in more distribution initiatives falling within the highly regulated distribution to non-qualified investors, as opposed to the somewhat less burdensome regime applicable to distributions limited to qualified investors (as described above).

Pursuant to the proposal, investors who have concluded a written discretionary management agreement with a regulated financial intermediary would no longer be deemed qualified investors.

In addition, today's qualified investor category of individuals with net financial assets of at least SFr2m (high net worth individuals, HNWI) would be substituted by an opting-in concept. Whereas today, every HNWI automatically is deemed a qualified investor, under the proposed rules wealthy individuals would have to explicitly declare their readiness to be treated as qualified investors and in addition, the possibility of opting in would be subject to those persons fulfilling certain conditions like evidence of investment expertise (MiFID-like knowledge and expertise criteria).

Preliminary assessment

Whether it is appropriate to also subject distribution activities merely aimed at qualified investors to quite severe regulation is a political question, the answer to which should also depend on how wide or narrow the qualified investor-exemption will be defined. Under the current proposal, even collective investment scheme distribution to prudentially regulated institutions such as insurers and large corporations with their own treasury departments would be subject to thorough licensing requirements. In fact, if the bill were approved by Parliament in the current form, non-regulated funds would likely disappear altogether from the distribution shelves for both individual and institutional investors in Switzerland. Considering that highly regulated investors such as life insurers are permitted under their own regulatory regime (subject to certain conditions) to invest a certain part of their assets in non-regulated alternative products such as private equity and hedge funds (see FINMA Circular 2008/18 note 324), it is questionable why an active advertising of such collective investment scheme to such types of investors should be factually suppressed in the future.

The MiFID-like amendments to the 'high net worth individual exemption' also are a political question. However, as a matter of principle, it seems difficult to reject FINMA's and the Federal Council's reasoning that the mere fact that an individual owns SFr2m should not be decisive when it comes to assess the need for investor protection under the CISA.

Caveat: Parliamentary debate going on and likely to lead to changes to proposal of Federal Council

The proposal by the Federal Council is being debated by the Swiss Parliament's summer session and from meetings of a preparatory commission there are signs that certain of the proposed rules will be slightly softened, such as the above-mentioned requirement of 'equivalence' for foreign supervision and regulations which may be changed to the less burdensome requirement of 'adequate' supervision and regulation. Further, as indicated above, it seems rather likely that the very restrictive regulation in the area of fund distribution will not be passed into law in the form as proposed by the bill.

The proposed amendments to CISA as described herein can be expected to be changed during the ongoing law-making process, and anyone potentially concerned by this piece of regulation should closely follow the parliamentary debate, this even more so as the law is expected to enter into force in 2013.

Pension schemes regulation

An (already adopted) amendment of the Federal Ordinance on Occupational Pension Schemes generally requires asset managers of Swiss occupational pension schemes to be prudentially regulated, i.e. licensed and supervised by FINMA, as from January 1, 2014. The law provides for the possibility of the competent authority granting an exception from licensing, unfortunately without indicating in any fashion which criteria would have to be fulfilled for benefitting from such an exception. Also, until now there are no precedents known under this exception rule.

Summary

A bill pending in Swiss Parliament will lead to regulatory changes in 2013 to the Swiss asset management and fund industry. The key elements of the proposed changes are the following:

- Swiss regulations and licensing requirements for the mentioned industry are strengthened in line with international regulatory developments (in particular the AIFMD) in order to ensure that Swiss market participants have a level playing field with their foreign competitors.
- The proposal shows a tendency for a certain 'Swiss finish' meaning that the new rules may be slightly stricter than in other highly regulated jurisdictions (EU, US); it remains to be seen whether Parliament will accept burdening the Swiss market participants with such additional requirements.
- The distribution of foreign non-regulated funds such as private equity funds and hedge funds in Switzerland may become significantly more difficult.
- The scope of private placements exemptions may be limited.
- A larger number of Swiss asset managers need to become supervised by FINMA; the delegation of functions are more strictly regulated.

Further, due to a change of pension fund law, as of 2014 asset management services to Swiss pension funds may as a rule only be provided by FINMA supervised institutions.

About the authors

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