

Switzerland: recent developments in the regulatory environment for alternative investment service providers

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In the wake of the recent crisis in the international credit markets, alternative investment funds are also a target for new regulations, while Switzerland and other prominent financial centres continue to compete to attract alternative investment funds and asset managers. This article outlines recent developments in the Swiss regulatory environment for alternative investment service providers.

The alternative investment sector is of considerable importance to the Swiss financial services industry. In 2006, private equity and hedge funds made up 6.7 percent of the contribution of the financial sector to the GDP and employed approximately 4000 people, compared to 4.9 percent and 4100 employees for the mutual fund sector. There is strong support in Switzerland's parliament and its executive branch of government for promoting the development of the alternative investment sector. The Federal Act on Collective Investment Schemes (CISA), which came into force on 1 January 2007, introduced two new legal forms for vehicles specifically intended for use by hedge funds and private equity investment funds: the limited partnership for collective capital investments (LLP) and the investment company with fixed capital (SICAF). The CISA has had limited success in attracting investment managers to use the new investment vehicles, however. As of December 2009, only seven LLPs have been established and a SICAF has yet to be formed.

The absence of a boom in the use of the new forms of investment vehicles notwithstanding, Switzerland continues to become more attractive as a business location for alternative investment fund managers. A recent study showed that many hedge funds and private equity funds are currently moving, or considering moving, all or significant parts of their operations to Switzerland. Well-publicised changes in foreign tax laws (e.g., in the UK and Germany) are not the only reason for this. Switzerland offers a high standard of living, a stable political and regulatory environment, an available pool of skilled professionals and a state-of-the-art financial infrastructure. In addition, Switzerland has a long tradition as the home of leading providers of private banking services. In 2005, Swiss firms managed almost 30 percent of the world's private banking assets. The proximity to both private banking and institutional investors has promoted the business of funds of hedge funds and funds of private equity funds in Switzerland since the mid-1990s.

Under the CISA and its implementing regulations, the regulatory framework distinguishes between collective investment vehicles established under Swiss law and those established under foreign law. Swiss-law investment vehicles are always subject to authorisation and supervision by the Swiss Financial Market Supervisory Authority (FINMA), but those established under foreign law only require authorisation by FINMA if they are publicly distributed in, or from, Switzerland.

Advertising is not deemed to be aimed at the public if: (i) it is directed to qualified investors; and (ii) only advertising methods customary for qualified investors (i.e., personal contacts and road shows) are used. Qualified investors under the CISA include regulated financial

intermediaries (such as banks, securities dealers and fund management companies), regulated insurance companies, certain public entities, companies with professional treasury operations, wealthy individuals and investors who have a written discretionary asset management agreement with a regulated financial intermediary. Asset managers also can be considered qualified investors if they fulfil certain requirements. A wealthy individual under the CISA means a person with financial investments with a value of at least CHF2m.

Swiss regulation does not distinguish between hedge funds and private equity funds and 'other' collective investment schemes. According to a guideline published by the FINMA, investor protection in Switzerland is to be achieved through transparency, information and the professional skills of the financial intermediaries rather than by barring the distribution of certain products. Therefore, alternative investment products, such as hedge funds and private equity funds can be offered to the public in Switzerland once they are approved for distribution by the FINMA.

In contrast to member countries of the European Union, for example, asset managers in general are not subject to authorisation and supervision by the FINMA. Asset managers of Swiss law collective investment vehicles, however, require an authorisation from the FINMA. Under the CISA, managers of foreign law collective investment vehicles may apply for a licence from the FINMA, if the foreign law requires that the asset manager is subject to supervision and the collective investment managed by them is subject to foreign supervision equivalent to Swiss supervision. The supervisory systems in the Cayman Islands and Bermuda, for example, are not currently considered equivalent.

Investment advisers whose activities are limited to research, analysis, and recommendations on investments of the fund do not require a licence from the FINMA if the actual investment decisions remain with the asset manager.

In late 2008, the Swiss Federal Department of Finance (EFD) announced that a circular on the taxation of managers of holding and management companies was being prepared. This measure was meant to make Switzerland even more attractive as a location for hedge funds and private equity funds by clarifying the taxation of performance fees and carried interest. Due to political factors, the circular has not yet been issued. This delay is not especially significant because much of the tax treatment desired by alternative investment managers can be obtained under the current law.

In January 2009, FINMA established an approval procedure of side pockets for Swiss funds of hedge funds. This measure allows such funds to separate illiquid assets from other assets and to suspend the redemption for a part of the portfolio. An approval of side pockets by FINMA requires, among other things, that no new units of the fund in question are issued or distributed. These requirements have been criticised because they might leave the funds with no other alternative than

liquidation.

On 29 April 2009, the European Commission proposed a Directive on Alternative Investment Fund Managers (the AIFM Directive). The draft directive has been subject to much criticism by the financial industry and amendments have been proposed by both the Swedish presidency of the European Union and Jean-Paul Gauzès, rapporteur to the European Parliament. The provisions on the delegation of the tasks of alternative investment funds are potentially significant from a Swiss point of view. Under the draft, each such delegation to third parties must be approved by the competent authority. For a delegation of the portfolio management function, the asset manager must be authorised as an alternative investment fund manager in order to manage an AIF in the same category. A delegation of portfolio management to an entity established in a non-EU country, such as Switzerland, would therefore not be possible under the draft. A delegation of administrative tasks will also be subject to the fulfilment of certain conditions. Potentially strict rules in the European

Union for the previously only modestly regulated alternative investment fund industry could also mean an opportunity for Switzerland. Deliberations on the AIFM Directive are still ongoing, so its consequences for Switzerland remain unclear. Amendments to the CISA or negotiations with the EU may be needed for Switzerland to maintain its competitive position.

A recent report by the EFD to the Swiss parliament emphasises that even though hedge funds and private equity investments are not reasons for the recent crisis in credit markets, stricter regulation is nevertheless being sought internationally. The report stresses that new regulation has to be realistic and objective, while retaining the competitiveness and the capacity for innovation of the Swiss financial centre. ■

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