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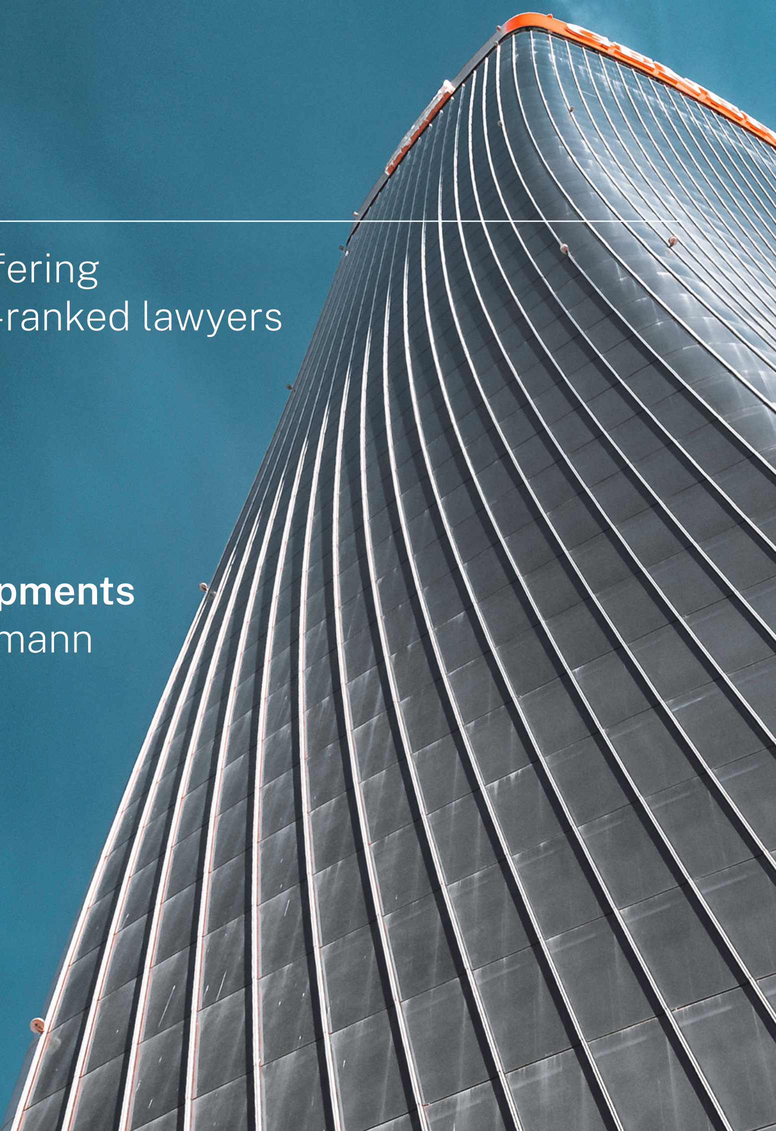

Switzerland: Trends & Developments

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Trends and Developments

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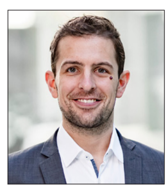

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Swiss Alternative Funds Overview

As a global centre for private wealth management, Switzerland plays an important role in the ecosystem of alternative funds, primarily as a market to distribute funds, but also as a base for asset managers. As financial markets are at an inflection point, with a period of historically low interest rates coming to an end, and are facing many uncertainties resulting in increased volatility, the demand for alternative funds remains strong in Switzerland.

The trends and developments in the industry broadly follow global trends but with a Swiss touch. This article will consider the four following trends and developments that are likely to shape the industry in the following years:

- The market is expecting a new structure for alternative investments: the L-QIF, which will be limited to qualified investors but will also not be subject to licensing requirements.
- The demand for sustainable and ESG-related investments has triggered closer scrutiny from the government, the regulator, the Swiss Financial Market Supervisory Authority (FINMA), and the industry itself, which will not leave alternative investments untouched.
- While it is not recent, the roll-out of the Federal Act on Financial Services of 15 June 2018 (FinSA) and the Federal Act on Financial Institutions of 15 June 2018 (FinIA), which entered into force on 1 January 2020, is reaching its conclusion and the law is increasingly affecting the market, among other things through relaxed rules on offerings of foreign investment schemes to qualified investors and the new licensing requirements applicable to portfolio managers and managers of collective assets.

The L-QIF: A New Structure for Alternative Investments

Until very recently, Switzerland had been poorly suited to setting up alternative investment funds and, consequently, asset managers tended to prefer other jurisdictions such as the Cayman Islands or Luxembourg to set up funds even if the investments were primarily designed for the Swiss market. In response to this phenomenon, the Swiss government proposed to create a new type of fund to reverse the trend and encourage the use of Swiss structures for domestic investors.

Therefore, after a smooth parliamentary process, a new bill amending the Federal Act on Collective Investment Schemes of 23 June 2006 to create limited qualified investor funds (L-QIFs) was passed into law on 17 December 2021.

The draft of the implementing ordinances was subject to a mixed reception in the consultation period and required a significant overhaul. The amendment is now expected to enter into force in 2024, once the ordinances are finalised. The act aims to create a flexible form of collective investment scheme under Swiss law, based on the model of the Luxembourg's reserved alternative investment fund (RAIF).

The L-QIF regime will allow Swiss fund management companies and, for limited partnerships for collective investments, Swiss managers of collective assets (but not self-managed investment companies with variable capital (SICAVs)) to set up a contractual fund, a SICAV or a limited partnership for collective investments, without seeking the prior approval or authorisation of the Swiss Financial Market Supervisory Authority FINMA, shortening the time to market, and reducing compliance costs.

As a matter of principle, investments in L-QIF will be reserved to qualified investors (Article 118a (1) (a), Collective Investment Schemes Act (CISA) as amended), such as institutional and professional investors pursuant to Article 4 of FinSA, elective professional investors pursuant to Article 5 of FinSA as well as private clients who have entered into a long-term portfolio management or investment advisory relationship with a regulated financial institution under FinIA or an equivalent foreign legislation (Article 10 (3ter), CISA). L-QIF investing in real estate will, however, be subject to stricter requirements and will be reserved to per se professional investors under FinSA to the exclusion of structures for high net worth individuals with a professional treasury (Article 118a (1) (b), CISA as amended).

As a further precaution to ensure appropriate supervision, L-QIFs can delegate (or sub-delegate) asset management to a Swiss manager of collective assets under FinIA – portfolio managers benefiting from the de minimis exemption under Article 24 (2) of FinIA will not be permitted – or foreign asset managers subject to appropriate supervision and regulated by a foreign supervisory authority which has entered into a co-operation agreement, if so required by foreign applicable law (Article 118g (2) and Article 118h (2) and (3), CISA as amended). Consequently, FINMA will nevertheless be able to supervise the L-QIF indirectly and ensure that the fund management company and the asset manager have the requisite knowledge and experience.

L-QIFs will not be required to follow specific investment guidelines or be subject to risk diversification requirements but will only be required to be transparent regarding these issues in the fund documentation (Articles 118n and 118o, CISA as amended). Accordingly, L-QIFs are not subject to restrictions for permissible investments and, therefore, allow investments in traditional asset classes such as securities, money market instruments and real estate as well as in more exotic asset classes, such as commodities, crypto-assets or art. Furthermore, since no risk diversification rules apply either, an L-QIF may invest all its funds in a single asset or a single type of asset – provided they can be readily valued and there is sufficient liquidity for redemption.

The L-QIF structure will accordingly be suitable for alternative investment funds using either non-traditional investment strategies or investing in non-traditional asset classes such as real estate, private equity, and private debt. It is also an appropriate structure for feeder funds investing in foreign investment schemes.

However, L-QIFs will be subject to the same limitations that are generally applicable to real estate funds (Article 118p (1), CISA as amended). In particular, the restrictions on related-party transactions (Article 63 (3), CISA), which may make the L-QIF difficult to use for sponsors seeking to restructure an existing real estate portfolio.

L-QIFs are subject to the same tax treatment as other Swiss funds and, accordingly, the L-QIF will be primarily suitable for investors in Switzerland or in jurisdictions with a tax treaty. This makes them primarily of interest to Swiss institutional investors as well as Swiss-domiciled high net worth individuals and clients of portfolio managers. As a practical matter, the authors expect pension funds to be the primary investors in this asset class.

ESG, Demand for Sustainability as Part of the Suitability Test, and Greenwashing

Another area of growth in the recent years has been the market for sustainable financial products, including in the alternative investment world. As part of this development, the number of ESG or other sustainability-related financial products has grown significantly. While this trend is not specific to alternative investments, it also affects them as investors query, as part of their due diligence, how investment funds seek, if at all, to consider ESG or other sustainability-related criteria in their investment policies.

Although in December 2020, the Swiss Federal Council adopted concrete measures to make Switzerland more sustainable as a financial centre with the stated goal of continuing to consolidate Switzerland's position as a leading location for sustainable financial services, this project has not yet led to specific legislative changes.

Therefore, the current focus on ESG and sustainability is of interest for products that take such factors into account, but also a concern for clients and investors who may be misled about the sustainable characteristics of financial products and services ("greenwashing").

Under current Swiss law, there are no specific rules (eg, under FinSA or CISA) against greenwashing. In particular, FinSA does not include any specific duties that indicate how a client's sustainability-specific preferences should be taken into account at the point of sale. Moreover, Switzerland has not followed the impulse of the European Union and attempt to regulate the taxonomy.

In response to the demand for ESG products and the risk of greenwashing, FINMA announced in its FINMA Guidance 05/2021 that it would focus its regulatory and enforcement policy on preventing greenwashing and deploy all instruments from its regulatory and supervisory toolbox to address this issue. For example, FINMA clarified the information that must be included in the documentation if Swiss funds are labelled as being sustainable. Regarding financial service providers and foreign funds, FINMA took the view that its powers are more limited as Swiss law does not provide for transparency requirements on sustainability at the point of sale and that it would not act until expressly mandated by law to do so. This is a conservative position as FINMA could have attempted to rely on the catch-all requirement of "fit and proper" to address potential shortcomings by banks, insurance companies, and other supervised financial institutions.

In June 2022, the Swiss Bankers Association issued its Guidelines for financial service providers on the integration of ESG preferences and

ESG risks into investment advice and portfolio management, requiring all member banks to determine, as part of their suitability test, what the preferences of their clients in terms of sustainability are and, on that basis, in an advisory relationship offer them products that meet their expectations. This instrument is binding on members of the Swiss Bankers Association but does not provide at this stage for an enforcement mechanism going beyond mandating an audit. Hence, non-compliance will not be specifically sanctioned, unless FINMA considers it as a minimum standard of self-regulation that needs to be complied with as part of the "fit and proper" requirement or if civil courts rely on this instrument to construe the specific requirements of the duty of care owed by an investment adviser or a portfolio manager under a contract of mandate. Nevertheless, this requirement, which applies only to financial service providers at the point of sale, may indirectly trigger additional demand for sustainable investments, including in the alternative investment environment to allow financial service providers to meet the expectations of their clients.

In December 2022, the Federal Council published a report on sustainable finance in Switzerland identifying four areas for action during the period from 2022 to 2025:

- sustainability data;
- transparency in the financial sector;
- impact investment and green bonds; and
- pricing pollution.

Among the fifteen measures that were identified in this area we are expecting a number of them to have a spillover effect in the asset management industry and in part in the alternative funds area. On this basis, we are expecting the Federal Department of Finance to publish shortly for consultation a draft bill on sustainable finance including potentially a taxonomy regime comparable to the one applied in the European Union under the Regulation (EU) 2019/2088 of 27 November 2019 on sustainability-related disclosures in the financial sector as well as a regulatory framework to avoid greenwashing. The project will also seek to bridge the gap between mainstreaming impact investments and investor protection, including suitability requirements. It remains, however, to be seen how these goals will be implemented and how they will be received in the consultation process. From the point of view of the alternative investments world, it will be important to see whether the legislation will be applicable to all funds offered in Switzerland or if foreign funds that are not offered to retail clients will also be concerned.

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