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Switzerland: Trends & Developments

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Trends and Developments

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New Investment Structures and Financial Regulations in Switzerland

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.
- In response to the low interest rate environment, the pension fund regulations were amended to facilitate investments in debt and infrastructure.
- The demand for sustainable 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 and is expected to enter into force by July 2023, once the implementing 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.

Alternative investments for a negative investment rate environment: infrastructure and debt funds

Although, on 16 June 2022, the Swiss National Bank increased the benchmark for interest rates for the first time in 15 years, interest rates remain historically low. Pension funds, therefore, remain under pressure to find investments with a sufficient yield to fund their benefits in the long term and have looked increasingly at alternative investments to achieve this goal. Two areas have seen increased interest from investors in Switzerland: infrastructure funds and debt funds.

Infrastructure funds as a separate asset class

In their search for long-term stable yields, institutional investors have often looked at investments in infrastructure as an alternative to government bonds. Indeed, this asset class often offers a stable, long-term income stream that matches the long-term investment horizon of pension funds and certain insurance companies. Moreover, from an economic and political perspective, there is also a public interest in encouraging investments in infrastructure in Switzerland and elsewhere.

To facilitate investments in this asset class, the investment guidelines of the Ordinance on Occupational Pensions of 18 April 1984 (known by its German abbreviation: BVV 2) were amended to allow Swiss pension funds and other institutions subject to these rules to invest up to 10% of their assets under management in infrastructure (Article 55 (f), BVV 2), as a separate category from the 15% share allowed for alternative investments generally (Article 55 (d), BVV 2). By default, investments in infrastructure funds will be permissible only as indirect investments through diversified investment funds (Article 53 (2) cum (4) BVV, 2) and are subject to the general restrictions applicable to alternative investments (Article 53 (4), BVV 2) as well as on restrictions on leverage, except as bridge loans to the extent required to cover capital calls or short-term finance (Article 53 (5), BVV 2). Pension funds may, subject to certain conditions that can be met by larger funds, depart from these rules, and engage in direct investments, but remain generally subject to restrictions including a ban on investments requiring follow-on investments (Article 50 (4), BVV 2), to the exclusion of pre-agreed capital commitments.

Overall, this will facilitate direct investments in equity or debt of infrastructure projects and facilitate the access to this asset class by a broader set of pension funds.

Growing interest for debt funds and potential for growth

Following the global trend, Switzerland has seen increased interest in debt funds from institutional investors, such as insurance companies and pension funds. Indeed, while these investors have long engaged in direct financing of Swiss commercial and residential real estate, the pressure to achieve positive and stable yield has led them to explore broader categories of debt than government and corporate bonds. In parallel, due to the Basel III requirements, banks in most major markets are subject to higher costs of capital and have tightened their credit policies. Together, these factors have led to the emergence of debt funds as alternative source of credit for borrowers and an interesting asset class for institutional investors.

This trend will be fostered by a change to the BVV 2, which entered into force on 1 January 2022, that treats direct debt as a separate asset class, in which pension funds can invest directly or indirectly through collective investment schemes (Articles 53 (1)(dter) and 53 (2), BVV 2). Subject to certain conditions, such investment does not need to be treated as an alternative investment. An important limitation for Swiss debt funds to qualify is, however, the requirement that at least half of the capital invested in private debt or private equity needs to be invested in Switzerland (Article 53 (2bis), BVV 2).

This is a challenge from a practical perspective as, currently, the Swiss market is mainly focused on distribution with little actual lending in Switzerland. Indeed, although the environment is ripe for creating debt funds in Switzerland, the tax treatment of debt finance puts non-bank finance at a handicap in comparison with bank loans. While interest on bank loans is not subject to withholding tax (WHT), the Swiss Federal Tax Administration recharacterises loans to a Swiss borrower by more than ten non-banks as a bond subject to WHT of 35% and considers, moreover, that a borrower who takes up credit from more than 20 non-banks as having issued notes which are also subject to WHT, making it complicated to raise financing from syndicates including non-banks, such as debt funds.

At the same time, the L-QIF may also make it easier to set up a debt fund in Switzerland, although it will only be interesting for Swiss investors as distributions by the funds will continue to be subject to WHT. In other words, the appetite for debt funds is likely to grow in Switzerland.

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.

More recently (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.

Ongoing roll-out of the Financial Services Act and Financial Institutions Act

Beyond the above-mentioned trends and developments, on a more mundane level, the alternative fund industry will continue to be affected by the ongoing implementation of FinSA and FinIA, which replaced the previous sector-specific regulations with a comprehensive framework governing financial services regardless of the provider and all financial institutions, with the notable exceptions of banks and insurance companies.

In this context, the new regulatory framework focuses on "offerings" of financial instruments (Article 3 (g), FinSA), including collective investment schemes (see, for example, Article 120 (1), CISA), rather than the broader concept of "distribution" used until then, although the practical impact of this change will be limited, because Article 127a of the Ordinance on Collective Investment Schemes of 22 November 2006 considers that the requirements applicable in connection with an offering are triggered by any form of advertisement for a fund.

At the same time, the new rules relax the offering of collective investment schemes by repealing the requirement to appoint a Swiss representative and payment agent for collective investment schemes that are only offered to qualified investors (Article 120 (4), CISA), but with the exception of schemes offered to high net worth individuals who have elected to be treated as professional investors, who continue to be subject to this requirement. As part of the transitory regime, Articles 105 (3) and 106 (3) of the Ordinance on Financial Services of 6 November 2019 provided that this rule would apply only if financial service providers offering the funds complied with the new rules of conduct and organisational requirements under FinSA. Now that the transition period has lapsed, fund managers can assume that financial service providers completed the transition and accordingly can forego appointing a Swiss representative and a Swiss paying agent if they do not offer their funds to elective professionals and private clients (other than qualified investors because they rely on the services of a portfolio manager or investment advisors).

Similarly, the enactment of FinIA carried an amendment to CISA repealing a licensing requirement for distributors of collective investment schemes, which, in practice, once secured was very light as it did not entail any ongoing supervision by FINMA and was consequently deemed superfluous and even potentially misleading. Instead, the new law relies on rules of conduct of FinSA as well as the requirement to register client advisers (see Article 28, FinSA) and, depending on to whom financial services are provided, join an ombuds-organisation (Article 77, FinSA) to ensure sufficient compliance by financial service providers that are not subject to supervision as financial institutions. As a practical matter, the burden of this new rule will be carried mainly by Swiss and foreign sponsors who seek to market their funds to Swiss elective professionals or to private clients. By contrast, financial service providers focusing exclusively on per se professional clients will not be subject to the requirement to join an ombuds-organisation (Article 77, FinSA) and may benefit from several reliefs from, and presumptions under, the rules of conduct.

Finally, the transition period for portfolio managers and trustees, who were previously only regulated for anti-money laundering purposes – including asset managers who acted on a de minimis exemption from the requirement to be licensed as a manager of collective investment schemes – to seek a licence from FINMA will come to an end on 31 December 2022 (Article 74 (2), FinIA). Based on data made publicly available by FINMA, it seems that many institutions have not yet taken the requisite steps to apply for a licence, taking the risk of having to cease any regulated activity subject to a licensing requirement, eg, by only providing services in connection with the sale or purchase of a financial instrument or investment advisory services, or expose themselves to administrative or criminal enforcement action for acting without a licence. Beyond reputational concerns, sponsors marketing funds in Switzerland should inquire into the status of their Swiss counterparts as clients of non-licensed portfolio managers will cease to be qualified investors under CISA (even if the service provider complies with the requirements of FinIA by acting only as an advisor and, more generally, complies with FinSA by registering its client advisors).

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