

# Marketing of hedge funds in Switzerland

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In the last few years, alternative investments and hedge funds in particular have become part of the standard asset allocation process in the Swiss private banking business as well as for many Swiss institutional investors. This is the case even though, given legal and regulatory constraints, hedge funds may only be distributed in Switzerland by way of private placement, without any public offering. In addition, Swiss law and the practice of the supervisory authority, the Federal Banking Commission, allow for the setting up and the public distribution of collective investment schemes which take different forms and which invest into hedge funds (e.g. investment companies, investment foundations, and funds of hedge funds). These structures have also contributed to the success of alternative investments in Switzerland. For the rest, the on-going revision of the Swiss mutual fund legislation is expected to create additional flexibility in regards to the offering of this type of investments to the Swiss market.

## The Swiss market

Switzerland is an important player in the alternative investment arena, especially for hedge funds. Although reliable statistics on this topic are difficult to come by, it is generally considered that, after the U.S., Switzerland is the second-largest market for hedge funds in the world.

A number of factors have contributed to this situation. Firstly, Swiss private banking and its sophisticated clientele have been among the first to invest in hedge funds, and to do so massively. With the years, a number of Swiss banks and financial advisors have thus developed an expertise in alternative investments. In parallel, Swiss institutional investors (e.g. pension funds) have been quick to include alternative investments in their asset allocation model. Recent changes in the applicable regulatory framework have further expanded the ability of these Swiss investors to invest in hedge funds, or funds of hedge funds.

## Legal and regulatory framework

The relevant legal framework as regards to hedge funds is the Swiss Mutual Fund Act of March 18, 1994 (the Act). The Act sets out a framework governing the setting up of Swiss mutual funds and the promotion of non-Swiss collective investment schemes in Switzerland. It has been implemented by a series of ordinances issued by the Swiss federal executive, the Federal Council, and the Swiss supervisory authority for mutual funds, namely the Federal Banking Commission (FBC). The FBC has further issued a series of circulars and published a number of decisions in the area of mutual funds. In particular, in May 2003 it issued an important circular dealing with the public offering of non-Swiss mutual funds, which is very important for the distribution of hedge funds in Switzerland (see below). It is also to be noted that the Act is currently being revised in order to broaden the scope and legal forms of regulated collective investment schemes.

## Swiss collective investment structures

It may look paradoxical that in spite of the importance of Switzerland in the area of hedge funds, no Swiss hedge funds have yet been created. The reasons for this are two-fold. Firstly, the Act only allows for the establishment of collective investment schemes having a contractual form (i.e. fonds commun de placement - FCP). This in turn requires the existence of a Swiss management company which needs to be licensed by the FBC. Corporate schemes, which are the most common legal form for hedge funds, do not fall within the scope of the Act. Also, the relevant legal and regulatory framework imposes relatively strict rules to Swiss funds, in particular with regards to investment restrictions (e.g. prohibition of managed accounts, risk spreading rules, limited leverage, etc). These rules conflict with the desire of hedge fund managers to secure a maximum flexibility in the management of their funds. Further, tax considerations are an obstacle to the setting up of a Swiss hedge fund. Thus, the Swiss Tax Administration considers Swiss mutual funds as transparent from a tax point of view. This results in the Swiss residents holding units in a Swiss collective investment scheme being taxed on the income generated by the fund regardless of whether or not

such income is distributed. This in practice is a problem for hedge funds, as these structures are typically growth funds. Further, Swiss collective investment schemes are subject to a 35% withholding tax which is applied on any dividend income distribution made by the fund, or upon redemption of the fund units. Although part or all of this withholding tax may be refundable depending upon the country of residence of the unitholder, this is a major issue for investors who are not Swiss taxpayers, as is the case with most clients in the Swiss private banking industry.

Notwithstanding the above, a number of structures have been set up in Switzerland in an attempt to tap the appetite of the Swiss market for hedge funds. Thus, since 1996, the FBC has allowed the setting up of Swiss funds of hedge funds<sup>1</sup>. These funds qualify as so-called high risk funds under the Act<sup>2</sup>. This structure has become increasingly popular over the years. Thus, a number of Swiss funds of hedge funds have been registered with the FBC and are publicly offered in Switzerland<sup>3</sup>. Another form of collective investment scheme which has been used in Switzerland in the alternative investment area is the Swiss investment company. By its features, such a structure is close to a fund of hedge funds, with however a number of differences. Typically, an investment company is set up as a Swiss corporation whose shares are listed on the Swiss Exchange. As is the case for a fund of hedge funds, the investment company invests (through an intermediary offshore holding company) into a portfolio of hedge funds. As opposed to a Swiss fund of hedge funds, such a structure is not regulated by the FBC or any other supervisory authority<sup>4</sup>. It is, therefore, not subject to any regulatory constraints concerning its investment policy and restrictions, which may be freely decided in accordance with its articles of incorporation and by-laws. Its creation and operation are therefore somewhat simplified. Also, the Swiss investment company is by law closed ended, the investors having no redemption right on their shares. In practice, this has often resulted in the creation of a discount of the share price as compared to its net asset value. As a result, these structures have now become much less popular than open-ended funds of hedge funds.

Another type of Swiss investment scheme which is used in Switzerland is the investment foundation. Its features are similar to those of a fund of hedge funds, although the investment foundation offers an enhanced level of corporate governance. The scheme is usually open-ended, the investors in an investment foundation having a right to redeem their interests. Furthermore, this structure is not governed by the Act, but by the general rules contained in the Swiss Civil Code applicable to foundations as well as by certain regulations applicable to pension funds<sup>5</sup>. The supervision is made by the cantonal or federal authority in charge of pension funds, depending upon the scope of activities of the investment foundation<sup>6</sup>. In practice, access to these schemes is limited to Swiss pension funds.

#### Distribution issues

As indicated, the current legal and regulatory framework precludes the setting up of Swiss hedge funds. As a result, fund promoters have looked into various ways to distribute their (offshore) hedge funds in Switzerland. In this context, it should be noted that, under the Act, the distribution of a hedge fund is treated in the same manner as any other non-Swiss mutual fund. Generally speaking, no professional offer of a mutual fund is allowed in or from Switzerland without the prior registration of the collective investment scheme with the FBC<sup>7</sup>. In practice, registration is, however, not an available option to hedge funds for two reasons. Firstly, registration is only available to a non-Swiss fund to the extent it has been set up in a jurisdiction which offers a level of supervision and of investors' protection which is comparable to the one offered by the Act<sup>8</sup>. This is, however, not the case concerning most jurisdictions where hedge funds are typically incorporated (e.g. Cayman Islands, British Virgin Islands, etc.). Furthermore, the registration of a non-Swiss fund presupposes its compliance with the investment restrictions (e.g. risk spreading, leverage limitation, etc.) which are applicable to Swiss collective investment schemes. As indicated, this constraint is usually a major issue for hedge fund promoters. In practice, it therefore precludes the public offering of hedge funds in or from Switzerland.

1 FBC 1996 annual report, 193.

2 Art. 35 (b) Act; Art. 44 of the implementing ordinance of October 19, 1994 ('10')

3 As of December 31, 2003, 57 Swiss 'high risk' funds (including sub-funds within one umbrella structure) have been registered with the FBC. Although no specific breakdown exists, one can say that this figure includes a majority of funds of hedge funds.

4 Art 3 (2) Act; FBC 1996 annual report, 194.

5 Art. 80 ss Swiss Civil Code; Arts 49 ss; 56 federal ordinance as regards professional plan for old age, survivors and invalidity dated April 18, 1984 (OPP2)

6 At the federal level, the competent authority is the Federal Office for Social Insurances (OFAS)

7 Art. 45 (1) Act

8 Art 45 (2) Act

In this context, it should be noted that the situation is markedly different for funds of hedge funds. These structures indeed do not face the same difficulties as hedge funds themselves. Indeed, funds-of-funds are often incorporated in jurisdictions which are deemed comparable by the FBC to the Swiss one, such as Luxemburg, Ireland, Jersey, or Guernsey. Also, the investment restrictions imposed by the FBC may usually be complied with at the level of the fund of hedge funds. That being said, the registration of a non-Swiss fund of hedge funds remains a rather complex and lengthy process in as much as, similar to a Swiss fund of hedge funds, it constitutes a high risk fund within the meaning of Swiss law. As a consequence, a filing with the FBC presupposes that a number of requirements be met by the fund, which have to do with the structure of the fund itself (e.g. ringfencing and local substance) as well as with the experience and qualifications of the fund management. As of December 31, 2003, 68 non-Swiss high risk funds, mainly from Luxemburg, were registered for public distribution in Switzerland<sup>9</sup>.

To be complete, one should also note that in the recent years, certain financial institutions have launched in the Swiss market funds-linked notes, whose proceeds are invested into a portfolio of hedge funds or, in certain instances, into one single hedge fund. Typically, the performance of the notes is linked to the underlying fund or portfolio of funds with generally a capital protection (upon maturity). For a while, the FBC has allowed the public distribution of this type of instrument in Switzerland provided they meet certain requirements having to do with the capital protection and credit rating of the issuer (or guarantor)<sup>10</sup>. More recently, the Swiss supervisory authority has, however, taken a more restrictive stance and limited the ability to publicly offer these instruments in Switzerland.

#### **Swiss private placement rules**

As indicated, any public offering of a fund in or from Switzerland triggers a registration duty with the FBC<sup>11</sup>. By contrast, the private placement of a non-registered fund remains permitted. The notion of public offering or solicitation is not defined by the Act or its implementing ordinances. It was, how-

ever, defined by the FBC over the years. This practice was recently codified in a circular issued on May 28, 2003<sup>12</sup>(the Circular). In essence, this Circular formalizes the pre-existing practice of the FBC, with certain changes.

In substance, the Circular defines the public offering as comprising any form of solicitation for the subscription of shares or units in a mutual fund, regardless of the type of media used for that solicitation (e.g. public advertisement, mass mailing, NAV publication, cold calling, roadshows, etc.). By contrast, a targeted offer to a limited number of investors remains allowed provided the number of investors contacted over a certain period of time (one year) is twenty or less. Also, the Circular provides for an exemption for institutional investors who may be contacted without any numerical limitation. The concept of 'institution' is narrowly defined in the Circular so as to include banks, securities dealers, fund management companies, insurance companies, pension funds, as well as large industrial or commercial groups. As opposed to the situation prevailing in other jurisdictions, that definition specifically excludes independent financial advisors (IFAs) and high net worth individuals (HNWI).

Furthermore, the Circular contains specific rules which are applicable to the promotion of unregistered funds by Swiss financial institutions (e.g. banks and IFAs) within the context of their asset management activities. These institutions may place unregistered funds in the portfolio of their managed clients. Thus, under the investment guidelines issued by the Swiss Bankers' Association ('SBA'), a portion of the clients' assets may be invested into alternative investments for diversification purposes. This presupposes, however, that the investments are structured as fund of funds or otherwise guarantee a risk diversification, and offer liquidity (through a redemption feature, for instance)<sup>13</sup>. On the other hand, financial institutions are not allowed, as a rule, to generally offer unregistered funds to clients with whom they only have a custodial or advisory relationship.

9 The same remark as for Swiss funds applies (see n. 3)

10 FBC 1999 annual report, 214.

11 Art 45 (1) Act ; Art 1a IO

12 FBC-Circ 03/1-Public offering

13 Art. 12, 2003 SBA Portfolio Management Guidelines

Finally, the Circular contains specific rules dealing with the offering of unregistered funds over the Internet. In this context, the FBC practice is somewhat liberal. To the extent a website is deemed to target Swiss investors based upon certain criteria (e.g. language, use of Swiss contact or references, etc.), certain steps need to be taken in order to comply with the Circular. The steps include a specific disclaimer as to the non-registration of the fund in Switzerland; this disclaimer must appear on the site and needs to be acknowledged by potential investors. The alternative is the setting-up of a system of passwords which effectively blocks the access by Swiss residents to information relating to unregistered funds.

#### **Conclusion**

Alternative investments and hedge funds in particular are now an integral part of the asset allocation process of Swiss asset managers and institutional investors. The existing legal and regulatory frameworks, as well as the practice of the Swiss supervisory authority, have allowed that evolution. Certain difficulties however remain, in particular in view of the narrow scope of the private placement rules and in the absence of any exemptions for accredited investors. In this context, the ongoing revision of the Act is a welcome development as it should improve the situation on both counts.