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The Changing Face of Alternative Asset Management in Switzerland

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Switzerland is the third largest global centre of alternative asset management, after North America and the United Kingdom. Around three times the size of Connecticut, the small, central European country boasts approximately 15% of global assets under management. This article examines the composition of the Swiss alternative asset management market, focusing on single managers and managers of funds of hedge funds (FoHFs); reviews the current and prospective regulatory environment in Switzerland for each type of manager; and assesses the country's future generally as a centre of alternative asset management against the backdrop of economic austerity and regulatory zeal in Europe.

At a Glance

- Switzerland is the largest centre in continental Europe for managers of alternative assets, with France coming second and Germany and the Netherlands a joint third.
- The main financial centres in Switzerland are Zurich, Geneva and Lugano.
- There is approximately US$7 trillion of assets under management by banks in Switzerland, approximately 60% of which are booked in Zurich, 30% in Geneva and 10% in Lugano.
- There is approximately US$100 billion of alternative assets under management in Switzerland held in single manager funds.
- There is approximately US$300 billion of assets under management in Switzerland held in FoHFs.

Single Managers

Switzerland has an approximate 5% share of the global single manager market. The country is home to 10 of the world's 30 largest single managers, together with around 500 smaller managers. There is approximately US$100 billion of alternative assets managed in Switzerland by single managers, around half of which is managed in Zurich with the balance split between Geneva and Lugano. Of that US$100 billion:

- 60% is held in Cayman Islands domiciled investment funds;
- 15% is held in British Virgin Islands funds;
- 10% is held in Luxembourg funds; and

- 5% is held in Guernsey funds.

Swiss single managers, operating largely outside the EU regulatory framework, have a demonstrable preference to house their assets in the leading "offshore" financial centres (principally the Cayman Islands) and, to a lesser extent, EU fund domiciles like Luxembourg.

FoHF Managers

There is approximately US$300 billion of assets under management in Switzerland and held in funds of hedge funds. Although having been hit hard by redemption pressures, illiquidity of underlying funds and the Madoff fraud during the past few years, Swiss FoHF managers control one-third of global FoHF assets. Switzerland is home to 6 of the world's 15 largest FoHF managers, the majority of which are in Zurich. Around 75% of Swiss FoHF assets are managed in Zurich, the balance in Geneva. Swiss FoHFs attract three-quarters of their assets from European investors, mainly institutional allocators, and this goes some way to explain the domicile choice for the FoHFs. Of FoHF assets of US$300 billion:

- 43% is held in Swiss domiciled investment funds;
- 29% is held in Luxembourg funds; and
- the remainder is held in Jersey and Guernsey funds.

In contrast to the domicile preferences of single managers, Swiss managers of FoHFs prefer "onshore" to "offshore" domiciles. The high level of allocations from EU institutional investors, such as pension funds, is the key driver behind their choice of EU fund domiciles over non-EU domiciles. See "Benefits and Burdens of Redomiciling a Hedge Fund to an EU Jurisdiction," The Hedge Fund Law Report, Vol. 4, No. 38 (Oct. 27, 2011). There will continue to be a demonstrable reliance by Swiss FoHF managers on assets from EU investors, and the changes being wrought by the Alternative Investment Fund Managers Directive (AIFM Directive) in the EU regulatory landscape is expected to have a significant impact on Swiss FoHF managers.

The Regulatory Landscape: Switzerland

The Swiss government and financial regulatory authorities have historically had a benign approach to the oversight of hedge fund managers. Only those managers selling fund products to the retail public in Switzerland are required to be licensed by FINMA, the Swiss Financial Market Supervisory Authority. The majority of single and FoHF managers take advantage of a provision in the Swiss Collective Investment Schemes Act (CISA) that effectively exempts managers selling to "qualified investors," broadly supervised financial institutions and their clients.

Investment funds domiciled outside Switzerland are not subject to any supervision by FINMA. Advisers to hedge funds are not subject to regulatory oversight or licensing requirements in Switzerland as long as they do not participate in the running of the fund and do not engage in brokerage activities. The Swiss Federal Banking Commission (SFBC) is considered to have sufficient oversight of the hedge fund industry through its supervision of the banks in Switzerland, which usually hold the assets and act as prime brokers, albeit primarily through their London and New York operations. To date, the SFBC's view has been that this kind of indirect regulation of the Swiss asset management industry is an adequate means of ensuring an appropriate level of macro prudential oversight.

European Union: AIFM Directive

Contrast the position in the EU. European and U.S. managers of non-EU funds are familiar with the spectre of exclusion from EU markets threatened since early 2009 by the AIFM Directive. The AIFM Directive is designed to ensure high level regulatory oversight of managers selling EU and non-EU funds to EU investors (institutional and non-institutional) by requiring managers to comply with rules on capitalization, leverage, mandatory disclosure and so forth. The AIFM Directive seeks to place EU-style regulation on non-EU countries by requiring them to implement cooperation agreements with regulators in EU member countries. In this way, the Directive shines an EU spotlight on non-EU countries where managers operate (like Switzerland) and where investment funds are domiciled (like the Cayman Islands).

For a time it was thought that the Directive would effectively prohibit the sale of non-EU funds into the EU. Thanks to a last-minute intervention by the U.S., the agreed version of the AIFM Directive strikes a short term compromise by preserving existing national private placement regimes in EU member states as the primary means of access to EU markets until around 2018. Around 2015 an EU "passport" (for non-EU managers) may be introduced. Thereafter the two regimes – private placement and passport – will run in tandem until around 2018, at which point the private placement regimes can, on the recommendation of the newly established European Securities and Markets Authority (ESMA) be terminated.

So Swiss managers, being outside the EU, have a mixture of options broadly comprising qualifying for the passport in 2015, continuing to place reliance on the private placement regimes of individual EU countries and utilizing UCITS as passportable vehicles for their funds. The ability of Swiss managers to access EU investors will, however, depend largely on the extent to which Switzerland is prepared to come to the EU table to ensure access for its financial services industry.

Switzerland: Three Responses to AIFM Directive

The AIFM Directive, which takes EU-wide effect in 2013, has had three immediate effects on the alternative asset management community in Switzerland.

Amendment of Collective Investment Schemes Act

To obtain the EU passport in 2015, a Swiss-based management company must firstly be registered with the regulator of an EU member state via an EU "Member State of Reference" (MSR). Rules are being developed that will govern how to determine which MSR is appropriate, it generally being the state with which the manager has the closest ties. If the fund is domiciled outside the EU, then appropriate cooperation arrangements must exist between the MSR regulator and the supervisory authority of the fund's domicile. If the fund is domiciled within the EU, then cooperation agreements must exist between the MSR regulator, the fund domicile's supervisory authority and FINMA. So it is clear that FINMA must have a cooperation agreement with non-EU domiciles like the Cayman Islands as well as the key EU domiciles like Luxembourg (the latter being the FoHF domicile for around 30% of Swiss FoHF managers).

In this regard, the first significant impact the AIFM Directive has had in Switzerland is to be found in the government's proposed changes to CISA. The changes, if enacted, will effectively raise the regulatory bar almost to EU levels with a view to agreeing to cooperation agreements with EU regulators, thereby ensuring the continuing ability of Swiss managers to access EU investors. Part of what is proposed is a reduction the application of the "qualified investor" exemption, thereby requiring all Swiss managers selling to qualified investors in Switzerland to apply for a licence from FINMA. This will entail full compliance by Swiss firms with the CISA rules pertaining to capital adequacy, corporate governance, reporting and so forth.

The changes to CISA are, at the time of writing, being discussed in a dialogue between Swiss government, financial regulator and industry bodies (notably the Swiss Funds Association) with an agreed position expected sometime in 2012.

Take up of UCITS

The second impact of the AIFM Directive on the Swiss asset management community is the attention on the part of FoHF managers (and some single managers) that it has focused on UCITS. UCITS enjoy automatic rights of distribution and sale in the EU. Non-UCITS (whether domiciled in the EU or elsewhere) do not. As an EU regulated investment product, UCITS can be sold throughout the EU to both institutional and retail investors. In addition to being attractive, fully regulated investment products for EU pension funds, UCITS open up to managers a previously forbidden client base: retail investors.

A significant portion of Swiss FoHF managers domicile their funds within the EU, increasingly in Luxembourg, in order to maintain their leading position in the European FoHF market. Dedicated Swiss FoHFs Harcourt, Man Investments/RMF and GAM have all launched UCITS FoHFs, as have several Swiss-based private banks such as Credit Suisse, Pictet, 3A (Bank Syz), Clariden Leu and EFG.

It should be noted that the UCITS framework does not provide for direct translation of portfolios of traditionally structured hedge funds into a UCITS compliant format; however hedge fund index replication techniques remain one option to provide investors with quasi-FoHFs exposure through a UCITS fund. Given the increasing number of hedge fund strategies being operated within UCITS-compliant structures, there appears to be an increasing opportunity for growth of a nascent Fund of UCITS Funds market driven by managers in Switzerland.

On the other hand, the greater pressure to generate higher performance returns experienced by Swiss single managers (in line with single managers the world over) makes the majority of them skeptical about UCITS. They point to the significant restrictions the UCITS regime imposes on use of leverage, shorting and derivatives, and the knock-on impact that has on returns (not to mention fees). For single managers, this is a serious downside of UCITS. The problem of lower returns and lower fees is compounded for investors and managers alike by the higher organizational costs involved with UCITS which are sky-high compared to the traditional Cayman private fund model. The slow and burdensome regulatory approval process, conservatively taking two to six months, is also a major turn-off for most single managers.

The majority of Swiss single firms manage non-EU, non-UCITS funds. If they want to sell those funds into the EU, they have a number of choices: continue to market their funds on a private placement basis (and comply with the new regulatory requirements imposed by the AIFM Directive); adopt full compliance with the AIFM Directive and obtain a "passport"; or go the UCITS route, either in alternative or addition to the traditional offshore products.

The AIFM Directive will not have an immediate impact on a large number of Swiss single hedge fund managers because they manage assets of less than EUR100 million (the Directive's applicability threshold). Whilst all managers in Switzerland (in line with managers in the U.S.) want to ensure continuing access to EU investors, the cost and burden of obtaining a FINMA licence would be largely unsupportable for a large proportion of Swiss single managers. The industry is expectant of a favourable outcome to the amendment of the CISA, and it can be sure of a favourable response from the offshore fund domiciles, particularly the Cayman Islands and British Virgin Islands, that are ready and willing to implement cooperation agreements with the Swiss regulator and EU regulators alike.

Boosting Offshore Substance

The third immediate impact of the AIFM Directive is an ongoing debate about the extent to which FINMA will permit the outsourcing of investment decisions by Swiss investment firms to foreign management companies. This structure, whereby the Swiss firm will provide "advisory and support services" to an offshore management company, which in turn will provide management services to the fund, has for some time been the paradigm means of achieving a tax-efficient repatriation of profits from the fund to the Swiss firm and its principals. Under the changes proposed to CISA, the delegation of decision-making to a foreign management company will be permitted if the foreign company is deemed to be subject to equivalent supervision and there is a cooperation agreement between the foreign regulator and FINMA.

This proposed change has coincided with a dissemination of AIMA's statements on corporate governance, together with increased scrutiny of foreign investment structures by Swiss tax authorities. See "Alternative Investment Management Association Publishes Institutional Investor Guide Covering Hedge Fund Governance, Risk, Liquidity, Performance Reporting, Investor Relations, Marketing, Operations, Valuation, Due Diligence and Other Topics," The Hedge Fund Law Report, Vol. 4, No. 19 (Jun. 8, 2011). The net result is a renewed focus on the "substance" of offshore management companies. Law firms in Switzerland are helping managers implement offshore substance and good corporate governance of their hedge funds in the following ways:

- Reviewing delegation arrangements between the Swiss investment firm, offshore fund and offshore management company;
- Providing fully insured and independent, non-executive directors to funds and management companies;

- Hardwiring substance provisions into the constitutional documents and service agreements of fund and management company;
- Reviewing arrangements for location and frequency of board meetings, and provision of advice on how offshore substance can be reflected in board papers; and
- Conducting a health check on a fund's board in light of the recent *Weavering Macro Fixed Income* case in the Cayman Islands, the subject of previous articles in The Hedge Fund Law Report. See, e.g., "Cayman Grand Court Holds Independent Directors of Failed Hedge Fund Weavering Macro Fixed Income Fund Personally Liable for Losses Due to their Willful Failure to Supervise Fund Operations," The Hedge Fund Law Report, Vol. 4, No. 31 (Sep. 8, 2011).

In line with their peers in the United Kingdom and, to a similar extent, the U.S., managers in Switzerland face a fourfold challenge: (1) increased prudential supervision; (2) amendment of local laws designed to ensure access to EU markets under the AIFM Directive; (3) increasing scrutiny by regulators and tax authorities of the "substance" of offshore structures; and (4) a heightened interest by regulators and investors in the corporate governance of hedge funds. The bottom line, though, is that these are industry developments that will be handled with confidence by managers in the world's third largest centre of alternative asset management.

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