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SWITZERLAND

The Swiss way to AIFMD

Switzerland's private funds industry is not unlike an industrious younger brother with aces up his sleeve, staying nimble for the long-term competition, writes Dante Leone of law firm CP-DL

In this article, we are going to provide evidence for an apparently indiscriminate conclusion: that younger siblings often turn out just fine, despite the odds being somewhat stacked against them.

Copious research studies have been published in the last 40 years showing that first-born children perform better than their younger siblings in many different respects. Among other things, they routinely obtain higher scores on IQ tests[1], do better in school[2], are less likely to use drugs or engage in crime[3], and, perhaps most importantly, are more likely to become president of the Unites States or portray James Bond in a motion picture.

In a nutshell, birth order has been recognised as a factor of success.

However, the reasons why birth order is important are not that evident. There are a number of theories, including genetics, undivided attention to first-borns, teaching dynamics among siblings, the stability of family life and the fact that parents put more effort into disciplining their oldest child.

For our purposes, this last theory is particularly fascinating: it posits that parents are particularly demanding of their first-born child, in part because they hope that this strictness will be perceived by their younger children, who in turn will be similarly driven to behave better. First-borns are thus the object of more attention, punished more for bringing home bad grades and generally held to a higher standard of behaviour. It's a sort of trickle-down theory applied to (differential) parenting.

***Leone**: Swiss relying on trickle-down*

AIFMD: A RECAP

So what exactly has that got to do with private equity or fund structures?

We are getting there. But a brief introduction on AIFMD is in order first.

As we all know, the last major shift in the European regulatory landscape for alternative asset management was the arrival of the Alternative Investment Fund Managers Directive (AIFMD), which came into force in July 2013[4].

Without rehashing the trauma that brought about the AIFMD, it is fair to say that, spurred by the financial crisis and great recession of 2008 and 2009, the European political class decided that not just banks, but also alternative fund managers posed a potential systemic risk to the stability of financial markets. And it sought to limit this risk by making sure that the business of alternative fund managers – which until that time had been conducted to a very large extent at the periphery of existing financial regulations – would be folded into a general regulatory framework.

Despite being rather alien from the leverage and sub-prime practices that were at the root of the crisis, private equity and venture capital fund managers were considered offspring of the same rowdy family of dangerous financiers (together with hedge fund managers and other alternative types). The AIFMD was the European response to the alleged public outcry for community control over the sector.

The AIFMD directive has an interesting structure. It is a piece of legislation built around the concept of regulating the manager, rather than the product, and it seeks to provide incentives to the newly regulated, in the form of clear rules for cross-border management as well as for placing products with investors throughout the European Union.

Because the focus of the directive is on

the manager, and specifically on applying common rules to Europe-based managers of alternative investment funds, one of the challenges was the treatment reserved to funds managed by organisations based outside of Europe.

It was clear even to the regulators that products managed by these so-called 'third-country managers' represented a very significant portion of alternative investment funds subscribed for by European investors. So the AIFMD reserved a special treatment for these managers: they would temporarily be able to continue placing their products with European investors based on national private placement regimes (to the extent left in place by the local legislators). And starting from two years after the coming into force of AIFMD (i.e. as of 2015), and no later than five years thereafter (i.e. by 2018), they would need to register with the EU authorities in order to access EU markets, thus receiving a 'passport' akin to the one granted to EU-based managers wishing to engage in cross-border marketing.

At the end of the five-year period, national private placement regimes (to the extent still standing) will be abolished, so that the harmonised EU regulations will remain as the only applicable legal framework.

1
actors who have portrayed James Bond who were not only sons or firstborns

24
out of 44 United States presidents were either only sons or firstborns

During the transitional period, the continued ability of third-country managers to rely on national private placement regimes is predicated to a very large extent on the conclusion of co-operation arrangements between the relevant third-country regulator and each EU financial regulator – although they are often negotiated centrally, on behalf of the national EU regulators, by the European Securities Market Authority (or "ESMA").

Now, when considering third-country managers, at the forefront of the EU regulators' minds were mainly two specific sets of situations: hedge funds based in offshore jurisdictions, and large global private equity funds managed by US-based organisations.

Alas, another significant constituency of industry players that was not necessarily the focus of the EU regulators' attention, and yet was very much affected by the AIFMD, was that of Swiss-based fund managers.

SWITZERLAND: THE YOUNGER BROTHER

And so we come to the younger brother: Switzerland. Switzerland is not just the 'little' brother in terms of surface area, population and long-standing national identity. It is also very much the younger brother in terms of evolution of its legal system (which borrowed heavily from the systems of neighboring countries) and regulatory framework.

Specifically, with respect to matters addressed at the level of the European Union, in the last 20 years Switzerland has taken the role of the (sometimes uninvited) follower, waiting for the enactment of EU regulations and then absorbing the portions that it has deemed useful and not otherwise detrimental to its own domestic interests of diversity, self-sufficiency and harmony. This process of unilateral incorporation of EU directives and constant awareness for euro-compatibility has become a prime guiding force for the Swiss legislator.

> ***One of the challenges [of AIFMD] was the treatment reserved to funds managed by organisations based outside of Europe***

Swiss financial regulations have also followed this pattern, when the local legislator has considered it appropriate. Swiss law on Collective Investment Schemes (or 'CISA') of June 23, 2006 was meant to bring Swiss regulations in line with EU rules on harmonized funds (so-called 'UCITS'). And, most relevant for our purposes, the latest changes to CISA (of September 28, 2012), as well as those to its accompanying ordinance on collective investment schemes (or 'CISO'), were modelled on the AIFMD but complemented by a Swiss 'finish'.

The bulk of the new Swiss rules came into force – after a general referendum – in March 2013, with a transitional phase for certain matters lasting from a few months up to two years form the entry into force of the main amended provisions.

THE SWISS STRATEGY

In connection with the regulations on fund management, both with respect »

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» to traditional harmonised funds and alternative products, Switzerland was aware that a lively base of Swiss-based fund managers is conducive to building a rich offer for managers of private client portfolios, which in turn are a major source of business for local firms.

It also recognised the importance of ensuring that its national fund managers had access to European financial markets; without that, there was a risk that a competitive Swiss financial market might not survive[5].

With these objectives in mind, Switzerland adopted a three-pronged strategy. First, it encouraged the creation of local products, namely Swiss funds in the form of Sicavs. Second, it set clear and simple conditions for the offer of Swiss and foreign funds to investors in Switzerland. And third, it created a regulatory framework allowing Swiss and foreign funds to be managed by local teams.

This is why Switzerland worked very hard to qualify among the first 'third countries' to enter into cooperation arrangements with the EU. Already in December 2012, FINMA (the Swiss financial market supervisory authority) and ESMA entered into a first co-operation arrangement, which was followed by memoranda of understanding entered into with EU member states in July 2013. These agreements permitted EU funds to continue being managed by Swiss-based teams, pursuant to delegation arrangements, in line with new rules governing the placement of these funds to professional investors in EU member states.

In the last 20 years Switzerland has taken the role of the (sometimes uninvited) follower, waiting for the enactment of EU regulations and then absorbing the portions that it deemed useful

AND WHAT DOES THE YOUNGER BROTHER LOOK LIKE?

Until the most recent changes to the Swiss regulations (CISA and CISO), the activity of Swiss-based asset managers – other than in respect of the management of Swiss collective investment schemes – was not specifically subject to regulation, but simply subject to supervision for the purposes of the prevention of money laundering and terrorist financing.

Under the new rules, almost all Swiss-based asset managers managing either Swiss or foreign collective investment schemes are subject to registration and regulation by FINMA. Additional financial guarantees in the form of a minimum share capital have been introduced, as well as requirements applicable to the qualifications, experience and independence of the members of the board of directors and other leading team components. New standards have been enacted for the organisation, the segregation of control function, the management of risks, the performance of compliance and conflict of interest duties and, more generally, the conduct of all members of an asset management firm.

True to the spirit of the AIFMD, the new regulations offer a de minimis exemption for firms managing qualified investors' assets of up to CHF 100 million or non-leveraged closed-end funds of up to CHF 500 million.

Asset managers are responsible for management duties and risk management of the relevant collective investment schemes, and may provide additional services such as discretionary management of individual portfolios, investment advice, distribution or representation of foreign funds. Fund management services may also be offered by Swiss asset managers to foreign funds, subject to the existence of a co-operation agreement between FINMA and the competent foreign regulator(s).

Swiss asset managers may in principle delegate certain asset management or ancillary services (such as compliance, risk or internal auditing) to third-parties, as long as the delegation is conducive to the proper management of the collective investment scheme and limited by the delegating manager's instruction, supervision and control over the delegated party. Investment decision duties may only be delegated to asset managers that are subject to prudential supervision by FINMA or an equivalent foreign regulator.

THE DISTRIBUTION OF FUND INTERESTS IN SWITZERLAND

Under the new rules, the sale in Switzerland of interests in unregistered foreign funds to supervised financial intermediaries (such as banks, broker-dealers, professional fund managers, insurances, pension funds and companies with professional treasury operations) falls within the private placement safe harbor, and as such it is not subject to prior authorisation from FINMA, to the extent that it is not carried out through a public offering[6].

> ***Swiss interest groups ... were worried that the combination of the foreign norms and the Swiss finish would subject nimble local firms to an unacceptable level of constraints***

A similar treatment is reserved for the sale of foreign fund interests to individuals having entered into a written discretionary management agreement with a regulated financial institution.

Instead, high net worth individuals – defined as individuals that either hold net assets of at least CHF 5 million, or hold (directly or indirectly) net financial assets of at least CHF 500,000 and have professional market knowledge comparable to institutional qualified investors – are not automatically considered as qualified investors, but may opt-in and request to be considered as such on a case-by-case basis (to a European professional, this will inevitably sound similar to 'professional clients on request' under the MiFID directive).

In any event, the placement of unregistered foreign funds interests with high-net worth individuals and pension funds or companies with professional treasury operations is always subject to the appointment of a Swiss representative and paying agent.

Any instance of distribution of a foreign fund in Switzerland that falls outside of this revised private placement safe harbor, requires the appointment of both a Swiss representative and a Swiss paying agent in any case, and more generally, a prior authorisation by FINMA, which is subject to a co-operation agreement with the competent foreign regulator.

WILL SWISS FUND MANAGERS TURN OUT JUST FINE?

The absorption of AIFMD-like rules into the Swiss framework had initially concerned several local interest groups, which were worried that the combination of foreign norms and the Swiss finish would subject nimble local firms to an unacceptable level of burdens and constraints.

So far, and in our experience, these fears have not materialised: FINMA has been working well with asset management firms, and greater weight has been accorded to proportionality rather than to the indiscriminate application of a fixed set of precepts.

Large Swiss firms that were already regulated have been given the comfort that they will continue to be able to serve their EU clients. Many smaller, yet-unregistered firms have been convinced to rise up to the challenge and improve their standards, in order to compete on a more level international competitive field. All of them may take solace in the knowledge that Swiss-based managers will have the chance to play a leading role in the alternative fund marketplace of the future.

Not unlike an industrious younger brother, it appears that Switzerland has noticed the level of discipline forced onto the first-born, considered its own destiny, and decided that slacking off was not the winning choice. And in so doing, it has safeguarded its viability as a dynamic partner for the European Union.

Perhaps sometimes trickle-down discipline does work – to the advantage of all. ■

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[1] See the Belmont and Marolla 1973 study on Family Size, Birth Order and Intelligence Test data, based on scores of nearly the entire population of 19 year-old Dutch men (386,114 subjects).

[2] See the Hotz and Pantano 2013 study on Strategic Parenting, Birth Order and School Performance, National Bureau of Economic Research Working Paper No. 19542, which concludes that earlier-born siblings will put forth more effort in school and end up performing better because, with respect to earlier-born children, parents are more likely to set higher standards and impose consequences for poor performance. So that parental reputation dynamics may explain part of the observed birth order effects in school performance.

[3] See the 2006 Argys, Rees, Averett and Witoonchart study on Birth Order and Risky Adolescent Behavior (Economic Inquiry, 44: 215–233) which, using data from the U.S. National Longitudinal Survey of Youth – 1979, investigated the association between birth order and adolescent behaviors such as smoking, drinking, marijuana use, sexual activity, and crime.

[4] July 2013 was the deadline for transposition of the directive into member states' national law. Not all EU countries obliged, and yet the AIFMD became effective at that time throughout Europe, irrespective of the completion of the transposition by the national authorities.

[5] Switzerland is the world's third largest financial market in Europe and the fourth largest trading partner of the European Union (which, unsurprisingly, is Switzerland's largest trading partner).

[6] The concept of 'public offering' encompasses all forms of direct and indirect marketing, although – also pursuant to case law by the Swiss supreme court dating from 2011 – the key principle is whether the group of individuals to which the offering is addressed is limited in number or due to particular relationships, based on the specific circumstances of the particular case at hand.

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