Distribution and Representation of Funds in Switzerland

Practical highlights

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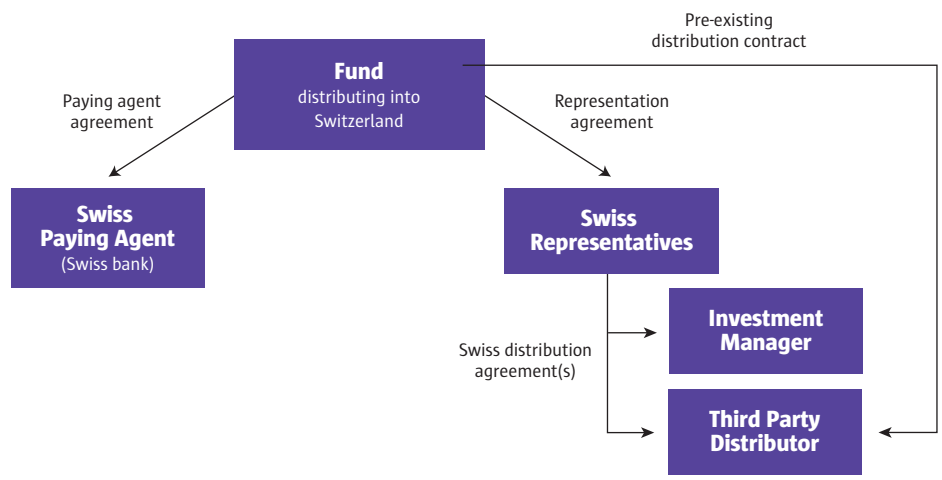
Switzerland's revised law pertaining to the distribution of funds has now become a well-known and documented matter. For the various duties and requirements of this law, it is highly recommended to refer to the Schulte Roth & Zabel "Top 10 Things You Should Know" article in this issue. The new framework has a number of advantages, leaving the Swiss qualified investor market accessible to all types of funds.

For a market that is currently faced with challenges surrounding private banking, this comes as a blessing. The Swiss regulator (FINMA) could have been a lot more restrictive, as observed with numerous of its European Union neighbours, such as Germany, France and Italy. The Swiss legislator, in revising its Collective Investment Scheme Act (CISA), has taken a different approach than the European Union with AIFMD – the Swiss focus has been entirely on distribution, the entity distributing and the regulation surrounding this entity. The resulting framework is pragmatic, easy to put in place, avoiding regulatory reporting or the need to establish a local presence, not too onerous, not protectionist and despite a certain number of flaws, not illogical.

The requirements designed specifically for a fund approaching only qualified investors is a natural fit for alternative investment funds. A variety of questions have appeared since early 2014, when Hugo Fund Services received its representative licence. Issues that were not envisioned upon the writing of the law are the most challenging to deal with from a practical standpoint. On such issues, there is little to no regulatory guidance, nor is there any established business practice to rely on. Not surprisingly, the law was written largely to fit traditional funds and to give the new Swiss law some degree of compatibility with the European UCITS and AIFM directives. However, when dealing with offshore fund structures, managers established across the globe, and distributors in varying regions, a number of interesting cases and situations have occurred where the representative has had to navigate unchartered territory through numerous discussions with the Swiss specialized legal community, consultants, auditors, and the regulator, as well as peers.

The transitory period to reach full compliance with the new rules ends on 28 February 2015. The putting in place of the representative, the paying agent, updating documents, preparing suitability checks and cleansing prospective client lists takes some time. Numerous investment managers started early. Hence, there are now already a number of funds that have initiated and completed the process. In an area where no business practice exists, discussing live examples is the only way to comprehensibly describe the challenges that come with the interpretation of the law for now.

Fig.1 Appointing a Swiss representative and paying agent *Source: Hugo Fund Services*



A certain number of frequently asked questions will be dealt with, but also a description of the more challenging questions and cases where the law simply does not provide a workable answer.

A few quick and easy questions to warm up:

- Question: Is the dispatch of a periodic distribution list containing fund reporting considered an act of distribution? Answer: Yes.
- Question: Is reverse enquiry exempted from regulatory requirements? Answer: Yes, but it must be a genuine and documented reverse enquiry, with no prior contact that can be traced back to the investment manager. Evidence of the reverse enquiry must exist in written format, and be kept for an extended period of time.
- Question: Can the representation be removed if there is no more active marketing? Answer: One of the purposes of the new regulation is to make sure that existing Swiss investors have a local interface to speak to. So the answer is yes, if no Swiss investors entered the fund and no, if marketing could obtain Swiss investors.
- Question: Are UCITS funds also required to appoint a representative? Answer: Yes – for as long as they approach non-regulated qualified investors. The law makes no differentiation as to fund structures.
- Question: Does the investment manager need to be regulated? Answer: No, if a regulated third party distributes the fund to Swiss qualified investors. However, should the investment manager wish to distribute its own fund, then yes, the investment manager needs appropriate regulatory supervision specifically relating to distribution, and needs to be "admitted" for fund distribution in its home jurisdiction.
- Question: Is a secondary or subsequent closing of a private equity fund considered distribution? Answer: Yes, if solicitation is made to qualified investors in Switzerland pursuant to the initial closing.
- Question: If an investment manager markets several funds, but only one has the representative appointed, can the others be included in the marketing material used in Switzerland? Answer: No, any reference to a fund will be compliant only if representation is in place.
- Question: Does the fund or the investment manager pay for the representation and paying agent? Answer: most of the time, the service is considered a necessary distribution expense and the fund carries the cost, but this will finally depend on the wording of the fund's binding documents (OM, prospectus, PPM, LPA, etc.) as well as on the investment manager who can choose to carry the cost.

Now that the practical sense is well established, a set of more complex cases can be looked at. The attempt is to underline the issues and challenges, not necessarily provide a comprehensive answer, which in some cases is not even feasible.

Case study 1: US investment managers

The richest universe in number of investment managers is clearly the United States. Different forms of registration for US investment managers exist depending on the markets they trade, such as registering as an Investment Adviser with the SEC, or with the CFTC, and applying for membership with the NFA. Additionally, registering as a broker-dealer with FINRA is also a possibility.

Foreign fund representatives have the duty to verify and demand proof that a foreign distributor operating in Switzerland is subject to appropriate

supervision in its country of domicile and is admitted for the distribution of collective investment schemes in its country of domicile. A well-known fact is that there is no such thing as an internationally recognized definition of distribution, and that the regulation of distribution differs considerably from country to country and within the same country from product to product.

The US offers a completely different regulatory landscape which, for the set-up and distribution of alternative funds, is largely based on two specific exemptions from the general provisions of the Securities Exchange Act of 1934 and the Securities Act of 1933.

Under the Swiss representation framework, the representative enters into the distribution agreement with the distributing entity – which often is the investment manager (see Fig.1). It is paramount for the Swiss representative to determine if it may enter into a Swiss distribution agreement with a US investment manager, which raises AUM in the US for its own private fund within the framework of the two exemptions mentioned above.

Importantly, following a number of months of research and discussion with various legal counsels both in the US and in Switzerland, we have concluded that it is possible to articulate the requirements of the CISA regarding distribution and the US regulatory framework, and thereby enable access for US investment managers to the Swiss qualified investor market under certain conditions.

Additionally, it should be mentioned that US entities which register with FINRA as broker-dealers or with CFTC/NFA shall be deemed to operate within a clearly defined and supervised regulatory landscape, making the signature of distribution agreements a simpler matter.

Case study 2 – distribution of managed accounts

CISA, as is incorporated in the name of the law, deals with collective investment schemes, i.e., pooled assets, generally considered pooled as of the presence of two unrelated investors. Therefore, reasonable deduction from this would lead to thinking that the distribution of dedicated managed accounts falls outside the scope of this law, and could be allowed.

This remains true as long as the managed account remains dedicated to only one investor. Should more than one investor have an interest in a managed account, it would be deemed to be a collective investment scheme, even though it does not have the usual attributes of a fund. Such a structure would therefore have to comply with the requirements of CISA.

Case study 3 – private equity funds

General Partners of Anglo-Saxon private equity vehicles and their third-party placing agents are often confused about their obligations – understandably so, as the CISA is probably the least matched for the private equity universe. Typically, the issues arising are the following:

- In the pre-launch marketing period of a private equity vehicle, the PPM generally is not finalized. However, the requirement to appoint a representative and paying agent applies. This leads to a bit of a conundrum, as the law does not provide guidance as to whether the offering of a "not yet existing CIS" is distribution or not. The answer can be found in the SFAMA (Swiss Fund and Asset Management Association) circular n°23/2013, which says that a solicitation can lead to the subscription of a CIS (and therefore constitutes distribution) if the promoter has at least established its main characteristics which include the investment policy, the main contracting parties and the fees. Based on this clarification, soliciting Swiss qualified investors with a draft PPM to invest in a PE fund to be formed at closing is distribution under CISA.
- The pre-launch marketing period is faced with a second issue linked to the first: namely, the duty to insert Swiss mandatory wording in the PPM before the closing date, with the representative needing to sign off on final documents used in Switzerland for marketing. The law provides no guidelines, but prudence suggests that a Swiss section should be inserted in the initial draft of the PPM and contain the mandatory Swiss wording, which implies at least the identity of the representative chosen by the promoter.
- How should the investment manager treat the cost incurred by appointing the representative and paying agent, which might end up being paid for even if no assets are raised with non-regulated qualified investors? LP structures usually provide for the General Partner to cover distribution cost. The result is often different for SICAF or SICAR structures.

The solution is to enter into the representation and paying agent agreements before investors' solicitation starts. Should no assets be raised from Swiss non-qualified investors, then representation need not remain in place. However, the obligation to maintain representation exists if a Swiss non-regulated qualified investor is invested, even if no active marketing is done – and this for as long as the investor is in place, generally for the life of the fund in the case of private equity vehicles.

Case study 4 – the paying agency agreement

The CISA has set an obligation for all funds distributing to non-regulated qualified investors to appoint a paying agent. The paying agent must be a Swiss bank. As a refresher, the investor will elect to use the paying agent or not upon subscribing to or redeeming from a fund. In practice the service is not used, and serves little or no protective purpose, as may have initially been planned.

The law obliges the conclusion of a formal paying agency agreement between the fund and the Swiss paying agent. The issue of whether the custodian should be part of the paying agency agreement is debated. Again, the law was designed for structures under UCITS and AIFMD, where custodians and depositories are mandatory, but completely ignores the situation of funds having no such function based on the instruments traded, e.g., certain long/short and pure short equity funds, managed futures funds, derivative strategies, real estate funds, private equity funds, hard assets funds, etc.

Solutions have been found between paying agents and Swiss representatives to tackle this lack of clarity and provide appropriate paying agency agreements.

Following the introduction of this new regulatory landscape, FINMA has created a new business opportunity through the requirement of representation for funds distributing to qualified investors only. This space is filled by several groups that are hedge fund specialists. The requirements that fall on this specific representation function and on funds entering the Swiss market under this regime are in a much lighter form than for funds catering to retail investors. The regulator has hereby been pragmatic and able to read the Swiss qualified investor market well, keeping it rich in investment opportunities but not restricting access to any type of fund.

However, as there is no existing business practice to rely on when faced with cases not envisioned by the law, these representatives have to take bold decisions. The lack of clarity affects a number of alternative investment funds, but solutions are generally being found. Clearly, a differentiating factor when selecting a representative will be the experience and variety of cases that have been dealt with so far. For investment managers looking to enter Switzerland, take time to understand the legal framework, get to know the representative, and try to obtain a good sense of their experience faced with complex issues. Most likely this will lead you to a safer choice than relying solely on price differential. **THFJ**