The abolition of the 'Swiss Finish' and 'Side Pockets' under Swiss law

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Abolition of the 'Swiss Finish'

To increase Switzerland's attractiveness as a distribution market for investment funds and to bring Switzerland in line with the Undertakings for Collective Investment in Transferable Securities (UCITS) III Directive, the Swiss Financial Market Supervisory Authority (FINMA), formerly the Swiss Federal Banking Commission (SFBC), decided to abolish the so-called 'Swiss Finish'. The FINMA believes that: 'The suppression of the "Swiss Finish" should contribute to reposition the Swiss Funds Market and promote Swiss Collective Investment Schemes'. This suppression, decided on 28 January 2009, entered into force on 1 March 2009.

Underlying the concept of the 'Swiss Finish' are the legal requirements imposed by Swiss law, which are more stringent than the regulations prevailing in other financial centres. For collective investment schemes, these requirements go beyond those imposed by the UCITS III Directive.

The rules designated by the term 'Swiss Finish' used to impose several obligations and prohibitions, partly of a material and partly of a formal nature. These included conditions for the collection of a performance fee, the so-called 'two thirds' rule, the 'Double-Dip' prohibition and some formal requirements linked to the loyalty and transparency duties with respect to investors in collective investment schemes publicly offered and distributed in and from Switzerland.

1.1 Performance fee

Under the 'Swiss Finish', the collection of a performance fee was allowed only under the following conditions: if its calculation referred to a benchmark or a hurdle rate and if the fund obtained a performance exceeding the selected benchmark or hurdle rate since the payment of the last performance fee. This rule had already been abandoned by the FINMA in March 2008.

Since 1 April 2008, the collection of a performance fee is possible if information related thereto complies with the duty of loyalty and of transparency in the information provided to investors as required under the Collective Investment Schemes Act (CISA). The method for calculating the performance fee must be provided for in the documents of the collective investment scheme.

1.2 'Two thirds' rule

The 'two thirds' rule derived from the SFBC's practice regarding protection against confusion or deception with regard to the designation of a collective investment scheme. (The principle itself of protection against confusion or deception stems from art 12 I CISA and art. 120 II lit c CISA). The purpose of the 'two thirds' rule was to prevent investors being misled by the name or corporate name of the collective investment scheme. This rule was applicable to Swiss and foreign collective investment schemes and required that a minimum of two thirds of the invested assets of the collective investment scheme comply with its designation, insofar as the investment strategy derived from its name or from its corporate name.

Since the abolition of the 'two thirds' practice, the FINMA no longer sets forth quantitative rules on the percentage of investments allowed relative to the name of the collective investment scheme.

Collective investment schemes still need to comply with the duties of transparency and loyalty towards the investors. But compliance, including the maintenance of binding documents, such as prospectuses, articles of association or fund contracts that avoid grounds for confusion or deception, is now the responsibility of the fund. In short, the collective investment schemes' documentation must not be misleading.

Intervention by the FINMA, as the supervisory authority, can occur when the above obligations are breached. This may happen during the procedure for obtaining approval for a foreign collective investment scheme to be publicly distributed in or from Switzerland pursuant to Article 120 CISA or at any time thereafter, in order to ensure compliance with Swiss regulations.

1.3 'Double-Dip'

Under the 'Double-Dip' prohibition, no issuance and redemption fees and only a reduced management fee (up to a maximum of 0.25 per cent) could have been charged when investing in affiliated target funds managed directly or indirectly by the fund itself, the fund's management company or its investment manager or by a company to which they are related through common management, control or in which they have a direct or indirect interest exceeding ten per cent of the capital or of the vote.

This prohibition was set forth in Article 31 of the Collective Investment Schemes Ordinance (CISO), which has been amended. The Swiss regulation went beyond the EU regulation by considering that a target fund was an affiliated fund if the direct or indirect interest exceeded ten per cent of the capital or of the vote and not just if the direct or indirect interest was significant, and by providing that only a reduced management fee could be charged. The EU regulation stipulates only that the amount of such a management fee must be published in a transparent way.

The new Article 31 CISO is in line with EU regulations. The CISO no longer lays down quantitative rules for management fees. It is now possible to charge a non-reduced management fee if its amount is clearly expressed in the binding documents of the collective investment scheme. The purpose of this rule is compliance with the transparency and the loyalty duties set forth in the CISA. The investors must be informed that a management fee is collected, and the fund's documents should disclose the calculation method thereof.

With this amendment, the UCITS collective investment schemes are deemed to be equivalent to Swiss funds pursuant to Article 120 II lit b CISA and no longer need to implement the above-mentioned Swiss version of the 'Double-Dip'. The 'Double-Dip' requirement has also been abandoned for the non-UCITS funds, which still need to be authorised by the FINMA after a full examination procedure.

1.4 Formal requirements

The 'Swiss Finish' also imposed compliance with several formal requirements derived from the transparency duty, such as the mention of (i) the risk and maximum limit of a possible leverage; (ii) the principle of segregated responsibility of the umbrella funds or the lack of segregation; (iii) the fact that the exchange risk cover between the different classes of shares may undermine the net asset value of another class of shares; and (iv) the information for Swiss shareholders.

All these specific Swiss requirements

resulted in delaying the authorisation procedure for foreign collective investment schemes in general and even for UCITS funds, which had to amend their documentation since Swiss law provided obligations more stringent than those of most EU countries.

As most of these formal requirements became unnecessary with the alignment of Swiss law with the UCITS III regulations, the FINMA decided to abandon them. A Swiss collective investment scheme is now deemed to be equivalent to a foreign UCITS one and vice versa. The authorisation procedure of a UCITS fund will therefore no longer be delayed, meaning that the UCITS foreign investment schemes will not have to amend their binding documents to comply with the rules set forth in particular in Article 120 CISA.

The only information that still needs to be added in foreign UCITS funds' documentation is that intended for Swiss shareholders, ie, the mention of the representative and of the paying agent and the payment of retrocessions and trailer fees. This information should be provided in accordance with the guidelines on transparency of the Swiss Funds Association (SFA), which are being amended following the rescinding of the 'Swiss Finish'.

With regard to the foreign collective investment schemes that are not UCITS funds and that do not comply with the UCITS III regulations, the formal requirements of the 'Swiss Finish' will also be abandoned, as the foreign non-UCITS funds may be authorised for distribution in Switzerland only if all the conditions set forth in Article 120 CISA are fulfilled. In other words, the equivalence of a foreign non-UCITS collective investment scheme to a Swiss collective investment scheme will be fully examined by the FINMA when it is requested to authorise the fund in Switzerland pursuant to Article 120 CISA.

1.5 Conclusion

Despite the abolition of the 'Swiss Finish', the FINMA still determines whether non-UCITS collective investment schemes are equivalent to Swiss funds when granting approval for distribution in and from Switzerland under Article 120 CISA. As far as UCITS funds are concerned, they are deemed to be equivalent to Swiss funds which facilitates the approval procedure before the FINMA. In conformity with its duty of supervision of the funds market, the FINMA can also intervene in cases of abuse after authorisation of the funds.

The foreign collective investment schemes, whether UCITS or not, must still comply with the loyalty and transparency duties towards the investors as required by the CISA. Important information should be fully and clearly disclosed in the documents of the collective investment schemes so as not to mislead investors, who need to be protected from confusion or deception.

The real practical difference resulting from the abolition of the 'Swiss Finish' is that the quantitative rules no longer apply. As a result, foreign collective investment schemes, and especially UCITS ones, have more freedom but also more responsibility to implement the above-mentioned loyalty and transparency duties when providing information to investors. Formal hurdles being removed, access of UCITS funds to the Swiss market should be facilitated.

FINMA authorises 'Side Pocket'

Through the creation of a 'Side Pocket', the illiquid assets of a collective investment scheme are separated from the other assets, and the investor's redemption right is suspended for this illiquid part of the assets.

Creating 'Side Pockets' is a decision of the fund or of the fund's management company and requires an amendment of the fund's contract. As with every modification of the fund's documentation, the introduction of a clause allowing the creation of 'Side Pockets' requires the FINMA's approval.

The FINMA authorises the creation of 'Side Pockets' for funds of hedge funds that are partially illiquid to avoid the suspension of the redemptions or the liquidation of the fund. The creation of 'Side Pockets' must be in the sole interest of the aggregate investors. 'Side Pockets' must be able to protect investors better than the two alternative measures provided by the CISA, ie, the suspension of redemptions or the liquidation of collective investment schemes. Indeed, the creation of 'Side Pockets' is a special measure authorised by the FINMA on a case by case basis but not provided for by law.

Moreover, the FINMA specifies that the issuance of new shares and the distribution of collective investment schemes that are partially illiquid do not usually comply with the CISA, especially not with the fidelity and information duties. As soon as a Swiss or foreign collective investment scheme is partially illiquid, the approval of public distribution in and from Switzerland will usually be suspended. If a foreign collective investment scheme that already has liquidity problems is trying to obtain approval to be publicly distributed in and from Switzerland, the FINMA will not grant such approval. The FINMA specifically recommends not issuing and distributing funds of hedge funds partially illiquid even those that have not created 'Side Pockets'.

Besides the creation of 'Side Pockets', collective investment schemes that are partially illiquid have other means of protecting the rights of the investors, such as the creation of gates. A gate is a restriction placed on a hedge fund limiting the amount of withdrawals from the fund for each redemption date.

From a Swiss point of view, gating has the same implications and consequences as 'Side Pockets', that is the fund will no longer be allowed to issue new shares nor to distribute them, as it is partially illiquid.

In view of the above, funds that are partially illiquid can, under Swiss law, use different means of protecting investors in order to limit the consequences of this problem. However, side pocketing or gating will suspend authorisation to issue new shares and to distribute the existing ones.