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Revision of the Collective Investment Schemes Act – Amendments to Custody

In the 2012 fall session, the Swiss parliament passed amendments to the Collective Investment Schemes Act (CISA). If a referendum is not launched, which it can be assumed will be the case, the revised act will enter into force at the beginning of 2013. By then, the ordinances to the revised CISA (revCISA) will also be available.

The reason for the revision was in particular the so-called Alternative Investment Fund Managers Directive (AIFMD) issued by the European Union (EU), which also applies to the European Economic Area (EEA), which namely includes Liechtenstein. Without an alignment of the Swiss act to the AIFMD, the sale of units in funds, which are managed from Switzerland, would be massively more difficult if not entirely impossible within the EU and EEA. Furthermore, the legislator would like to strengthen the competitiveness of the Swiss financial centre and expand investor protection with this revision.

The amendments overwhelmingly concern the portfolio management of collective capital investments, their distribution and their custody. We are discussing these amendments in three publications. This publication deals with the amendments in the area of custody.

1. Authorisation requirement only for the custodial banks of Swiss collective investment schemes

The fact that custodial banks needed to have a custodial licence in addition to a normal banking licence has long been applied in accordance with art. 13 para. 2 let. e CISA; therefore, custodial banks qualify as licensees under CISA. What is new is that such authorisation is only necessary for custodial banks for Swiss collective investment schemes (art. 13, para. 2, let. e revCISA). However, if a Swiss bank acts as a custodial bank or as a custodian (without actual custodial bank functions) for a foreign collective investment scheme, *e.g.* a Cayman Fund, it does not require any additional FINMA authorisation for the exercising of this function; an orderly bank licence is sufficient. FINMA would also not grant such a licence even if the bank were to apply for one.

Analogous to this, art. 72 para. 1 revCISA, specifies that a custodial bank does not only have to be a bank in accordance with Swiss Banking Act. Much more, it is also required that the custodial bank has an appropriate organisation as a custodial bank for a collective investment scheme. Through this provision, an explicit legal basis is created for the requirements which FINMA spells out for custodial banks in its «FINMA guidelines for applications related to licencing as a custodial bank, changes within the custodial bank, switching the custodial bank.»

2. Requirements for the appointment of third-party and collective custodians (sub-custodians)

Art. 73 para. 2 and 2bis revCISA regulate the safekeeping of fund assets by sub-custodians. The appointment of sub-custodians was already permissible under the current law (art. 73 para. 2 CISA). And, as now, it will be required that the prospectus provides information about any risks associated hereto. This is done in the sample prospectus of the Swiss Funds Association (SFA) as approved by the FINMA under section 3.

However, now requirements will be established which concern the sub-custodians:

- On the one hand, the appointment of a sub-custodian must be in the interest of proper safekeeping (art. 73 para. 2 sentence 1 *in fine* revCISA). This is given in most cases, since the custody of financial instruments of foreign issuers at a Swiss custodial bank would hardly be practicable.

- On the other hand, financial instruments may only be safeguarded at supervised sub-custodians (art. 73 para. 2bis revCISA). No specific requirements are defined for the supervision of these sub-custodians; in particular, it must not necessarily be equivalent to Swiss supervision. Exceptions from the supervision requirement are possible, for instance if custody must be done at a location, where the appointment of a supervised sub-custodian is not possible, such as, for example, when mandatory legal provisions or modalities of the investment product demand this. This could apply for shares in hedge funds, which are issued as «inscribed shares» and, as a rule, are considered as on deposit with the Registrar, or for securities from issuers in emerging markets, where the custodians are not subject to supervision.

E contrario it must apply that assets, which are not financial instruments, may also be safeguarded at non-supervised sub-custodians. This will be true, for instance, for precious metals (such as gold) and commodities.

As a transitional regulation, art. 158b para. 2 revCISA mandates that custodial banks must confirm to FINMA compliance with the rules spelled out in art. 73 para. 2 and 2bis revCiSA within two years.

These regulations on the appointment of sub-custodians conform *grosso modo* with the terms and conditions of art. 21 para. 11 AIFMD. The differences are primarily based on a more detailed listing of the requirements in the AIFMD, but should not be considered materially relevant.

3. What is the custodial bank liable for when appointing a sub-custodian?

The legal revision of the liability regulations for sub-custody was controversial and was awaited with great expectation by all sides. The general liability principles for delegation prevailed also with reference to the custodial bank (art. 145 para. 3 revCISA). This provision provides that a licensee, who transfers a responsibility to a third party, is liable for any damages caused by this third party unless he can prove that he applied the due care required by the circumstances during selection, instruction and monitoring. This liability standard will be stricter than that under existing law (art. 73 para. 2 CISA) and

than that under art. 33 para. 2 Federal Act on Intermediated Securities (*Bucheffektengesetz* or FISA). But it is milder than the practically strict liability of the custodian stipulated under art. 21 para. 12, AIFMD, which provides for a liability release only in cases of acts of God. This will make the distribution of Swiss funds practically impossible in the EU and EEA.

4. Legal revision of the custodial bank activity of Swiss SICAVs

Art. 44a revCISA will mandate that every Swiss SICAV requires a custodial bank under art. 13 para. 2 let. e CISA, on which the terms and conditions of art. 72–74 CISA find application. Until now, this was not provided for under the law, but demanded by FINMA.

Art. 44a para. 2 revCISA will allow for exceptions from this. For instance, FINMA may issue a release from the appointment of a custodial bank when cumulatively (i) the SICAV is only open to qualified investors pursuant to art. 10 para. 3 – 3ter CISA, (ii) instead of the custodial bank, one or more institutes, which are subject to supervision equal to that in Switzerland, carry out the transactions linked to the matter and are specialised in such transactions («prime brokers»), and (iii) it has been ensured that the prime brokers or those foreign supervisory authorities responsible for monitoring the prime brokers provide to FINMA all information and transmit all documents, which it requires for the fulfilment of its responsibilities.

A comparable regulation is already in place in art. 71 para. 5 CISA, for contractual type «other funds for alternative investments.» Through this, the special case results where a SICAV of the type «securities fund» or «other fund for traditional investments» can have authorised the appointment of a prime broker in place of a custodial bank, while this is not possible for a contractual type «securities fund». The Federal Council justifies this through the situation that the legal form of the SICAV grants investors broader rights than a contractual fund for which reason a SICAV is more likely to not need the involvement of a custodial bank.

In practical terms, this exception regulation will remain of limited interest. On the one hand, there are only a few SICAVs under Swiss law, and, on the other, they must fulfill the three requirements mentioned. In other words, they must pursue a strategy, which requires the inclusion of a prime broker.

A similar arrangement is provided for under art. 21 para. 4 let. b AIFMD: A prime broker may only act as a custodian when a functional and hierarchical separation of the performance of the custodial function from the responsibilities of the prime broker is present and any possible conflicts of interest are properly identified, steered, observed and presented openly to the investors (art. 23 para. 1 let. o AIFMD).

The amendments, which the revision of the CISA entails in the area of portfolio management and distribution, are treated in a separate publication. You may also find this on our website at *www.kellerhals.ch*

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