Hedge Funds

Jurisdictional comparisons **Second edition 2014**

Foreword Robert Mirsky Global Head of Hedge Funds, KPMG

Introduction Kumar Panja Global Head of Prime Brokerage Consulting, J. P. Morgan
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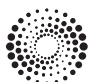
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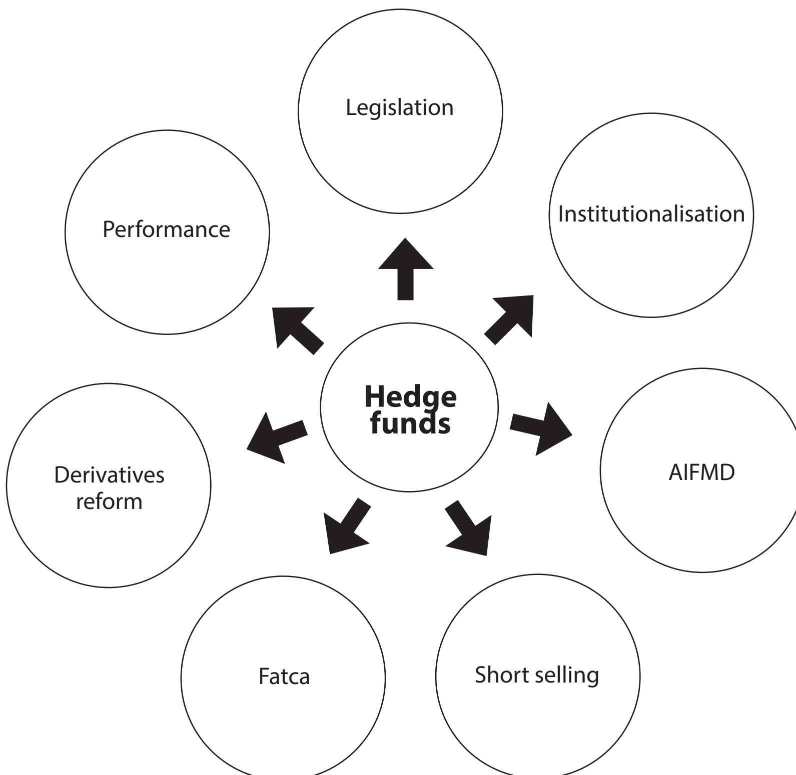
Foreword

Robert Mirsky Global Head of Hedge Funds, KPMG

The global financial crisis of 2008 continues to significantly impact the hedge fund industry through its ripple effect on global legislation, regulation and investor confidence. The current and impending reforms have come to the fore post financial crisis and will remain hot topics over the coming years.

Collectively, these reforms construct an extensive list of buzz words. In Europe, that list includes AIFMD (Alternative Investment Fund Managers Directive), MiFID (Markets in Financial Instruments Directive), and EMIR (European Markets Infrastructure Regulation) among others. In the Americas, the most notable reforms are SEC and CFTC regulation and the Dodd-Frank Act and FATCA (Foreign Account Tax Compliance Act). Globally, the hedge fund industry is impacted by countless reforms; including European short selling bans, global derivatives reform and shadow-banking.



Despite these reforms, the hedge fund industry continues to thrive; with $2.4 trillion in assets under management in the first quarter of 2013. The industry has also generated greater than average returns, after fees, over the past two decades than a traditional portfolio, including stocks, bonds and commodities. This has forced financial markets to take notice. Capital inflows are increasingly coming from institutional investors to provide diversification to conventional portfolios and generate alpha through actively managed strategies. The operational infrastructure of funds and their managers are also evolving as institutional sector investors – including endowments, pension funds and annuities – demand a higher degree of transparency.

Regulation and legislation

The hedge fund industry is suffering from regulatory overload. With draft legislation, numerous consultation papers and public responses introduced almost weekly, industry participants are struggling to wade through the information and determine their course of action. Hedge fund managers are turning to their service providers to help them sift through it all.

AIFMD

AIFMD was published by the European Commission in December 2012, giving member states until July 2013 to adopt it into national law. The Directive aims to increase investor protection, reduce systemic risk and provide a harmonised set of rules for investment firms to operate under in the European Union. This includes the highly debated remuneration code which may dramatically impact the way the industry pays itself. In effect, the Directive is changing the way the industry thinks and raises the cost benefit question among industry participants as they decide whether the future of their business is European. However, the impact of this Directive will be felt far beyond Europe.

Short selling

Globally, short selling regulation aims to provide increased transparency and clarity intended to benefit both investors and regulators. Importantly, regulators will be able to monitor the systemic risks created by short selling and the interdependent market abuse. In practice, this mandate requires investors to report significant short selling positions to the relevant regulatory authorities and places a ban on 'naked' trading. This differs from the past where market participants were able to sell positions prior to having any contractual borrowing agreement. In addition, the mandate grants the public access to some of the information provided by the mandatory reporting; including significant positions and existing penalties. The short selling regulation in Europe expands upon the existing Regulation SHO in the United States implemented in January 2005, which deems that failure-to-deliver positions must be closed within 13 consecutive settlement days before the broker or dealer can transact further short sales. The ban is forcing investment managers to question whether the increased reporting

requirements and associated cost is greater than the returns earned from the market. As a consequence, investors may deem long/short funds too expensive and turn toward the more traditional long only fund manager who can promise absolute returns at a lower cost.

Institutionalisation of an industry

With the influx of capital from institutional investors into the hedge fund industry, it is becoming increasingly apparent that this influx comes at a cost. According to a recent survey, 'institutional investors now represent the majority of all assets under management by the global hedge fund industry, with 57% of the industry's AUM residing in this category.' The focus of these investors when looking at absolute return products has focused on risk management and compliance practices. Further, hedge funds need to be better resourced to deal with the increased volume of information and due diligence required by the more sophisticated investor. In the past, an investment manager was able to start up a hedge fund with less than $50 million in assets under management. The amount required to do so today is significantly higher due to additional compliance costs. In fact, the additional cost of compliance has raised the question as to whether this will act as a barrier to entry for new investment managers. For others it has raised the question whether the hedge fund industry can continue to be an efficient mechanism or whether the infrastructure burden will become too cumbersome to operate.

This book aims to demystify the evolving legal and regulatory landscape and act as a guide to successfully navigate the shifting global marketplace. Specifically, it seeks to provide insight into the challenges faced by the global hedge fund industry – broken down by jurisdiction – as participants struggle with the increased infrastructure burden and the resulting operational and compliance costs.

London, November 2013

Introduction

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Since the last edition of this book, mitigating counterparty risk remains firmly on the agenda of alternative asset managers. While the immediacy of those catalysts may have subsided, the management of this risk is now a deeply entrenched practice within the risk management framework of an alternative asset manager, as well as being a key area of assessment for its investors. So from this perspective, the provision of asset segregation solutions by prime brokers to asset managers continues to remain important, however, the level of participation between the specific segregation solutions varies.

In the rush immediately after the financial crisis for prime brokers to provide segregated asset solutions, it has been the period since then that the depth, flexibility and general viability of those solutions has been tested. The provision of the Special Purpose Vehicle (SPV) model by a number of prime brokers has raised questions for some asset managers, not only surrounding the legal framework of such a provision, but also focusing on the operational robustness of the service, particularly when considered against the ongoing appetite of those prime brokers to invest in the service.

Equally, the model that has seen a number of the industry's prime brokers choosing to partner with a third party custodian, has also been said to have had limited take-up among asset managers.

This segregation solution offers the benefit of having unencumbered assets held by a separate institution, but feedback from asset managers has suggested that there are a number of drawbacks in practice. These include: the additional operational risk introduced by having assets flow between two separate organisations; as well as the appetite of the prime broker to introduce a third party to their client, particularly in a world where such third parties may be broadening their service capabilities to include those currently provided by a prime broker.

It is the third solution, the prime custody service, namely where the same institution brings together its established prime broker and custody business lines, where asset managers appear to have shown the keenest interest. While an asset manager will need to become comfortable with having the custodian and prime broker housed in the same institution, the combination of linking to an established custody practice as well as keeping the client relationship maintained within the same organisation, appears to answer some of the concerns raised by the other two asset segregation solutions.

However, it has been the ability to link the prime custody service into

another market trend that has further provoked interest for a number of alternative asset managers. Specifically, over the past few years the industry has witnessed the migration of alternatives strategies into the registered mutual fund marketplace, whether that be 40 Act mutual funds, or its equivalent in Europe, UCITS. Recognising this trend, a number of the universal banks have positioned their integrated prime custody and prime brokerage offerings to meet an alternative asset manager's high-touch service and financing needs, while providing for the specific regulatory requirements demanded for the segregation of assets.

In summary, whichever way an asset manager decides to manage its counterparty risk, it remains on top of the agenda and prime brokers are prepared with solutions to help answer this need. No doubt asset managers have become more informed as to the benefits or otherwise of each of the segregation solutions being offered and while prime brokers will continue to offer a variety of solutions, it is likely that asset managers will migrate to those providers who can not only answer counterparty risk, but also deliver it in a way that complements asset managers' need for efficiency and the growth of their businesses.

London, November 2013

Switzerland

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1. HEDGE FUND MARKET

1.1 Facts and figures

Switzerland plays two important roles in the global fund market due to its importance in the global asset management business.

On one hand, currently about 6,100 foreign collective investment schemes are authorised for distribution in Switzerland (Source: Swiss Financial Market Authority (FINMA)). A majority of more than 5,800 of these collective investment schemes, amounting to approximately CHF 600 billion, are undertakings for collective investment in transferable securities according to the European Union Directives 2001/107/EC and 2001/108/EC (UCITS) and are mostly domiciled in Luxembourg, Ireland and the Principality of Liechtenstein. This means that about 80% of the mutual funds distributed in Switzerland are foreign funds. In addition to this, assets of around CHF 630 billion are invested in foreign funds which have not been authorised for public distribution (Source: Swiss Funds Association). Thus, Switzerland is one of the very important sales markets for foreign funds.

Investment managers of collective investment schemes domiciled in Switzerland manage both a significant proportion of European UCITS, as well as alternative investment funds (AIF). Switzerland has always been considered an important player in the placement of alternative investments, especially hedge funds. It is difficult to obtain reliable figures, but it is estimated that 22% of the global funds of hedge funds market, amounting to CHF 420 billion is managed in Switzerland. These alternative investment funds have traditionally been domiciled in the Cayman Islands, British Virgin Islands, Bermuda or the Channel Islands of Guernsey and Jersey. The provision of asset management services for overseas domiciled funds is in fact a core element of the Swiss fund market. The single hedge fund market managed from Switzerland is estimated at CHF 24 billion. In comparison, the total assets managed by fund of hedge funds which are actually themselves domiciled in Switzerland amount to approximately CHF 10 billion.

The vast majority of hedge funds which are distributed in Switzerland are funds of hedge funds. The reason for the predominance of funds of hedge funds over single hedge funds can be explained by the requirements set out in the Portfolio Management Guidelines of the Swiss Bankers Association (SBA) of 2010. According to these Portfolio Management Guidelines – the rules of which have to be adhered to by all portfolio managers of banks and are best practice for all non-bank portfolio managers

– non-traditional investment instruments may be utilised for the purposes of portfolio diversification if they are structured according to the fund of funds principle (or offer a similar degree of diversification) and guarantee ready marketability. Collective investment schemes are regarded as readily marketable when investors are able to terminate their investments after reasonable notice according to the Swiss Federal Act of 23 June 2006 on Collective Investment Schemes (Collective Investment Schemes Act, CISA).

In 1995, Switzerland introduced a framework allowing foreign hedge funds to seek approval for public distribution. However, since then only 178 other funds for traditional investments and 74 other funds for alternative investments have been authorised for distribution in Switzerland (Source: FINMA 2012). In fact, most hedge funds distributed in Switzerland have not been open to public distribution in or from Switzerland. The main reason for this is that there was no need to seek public distribution, as advertising was not deemed to be public if directed exclusively towards to qualified investors, who are the main investors in hedge funds. Moreover, most offshore jurisdictions would not have met the FINMA's requirements as to the level of supervision applied to funds domiciled in their jurisdiction.

The majority of hedge funds managed in Switzerland are still domiciled abroad in an offshore jurisdiction. The Swiss market therefore has historically not been a 'producer' of hedge funds and the functions performed in Switzerland have predominantly been of an auxiliary nature, ie, marketing and distribution, research and analysis or advisory services. The main reason for this is that previous legislation allowed only for open-ended contractual investment funds, which again required a Swiss fund management company regulated by the FINMA. The use of a limited partnership, as the typical single hedge fund structure, was not allowed as a legal entity for collective investment vehicles. In addition, the investment restrictions were too tight to reasonably accommodate the hedge fund industry. In 2007 new legislation came into force which provides for the possibility to incorporate limited partnerships for the purpose of collective investment schemes and investment strategies which allow for great flexibility in determining the investment policy.

1.2 Recent developments

Historically, Switzerland had an uninviting tax regime and certain legal restrictions on hedge funds, which compared disadvantageously with other jurisdictions.

At the end of 2012 a joint working group comprised of the SBA and the Swiss Fund Association (today Swiss Funds & Asset Management Association (SFAMA)) put forward eight areas for action that shall provide an optimal operating framework. These are: establishing asset management as a brand; developing and applying standards for asset management; ensuring appropriate regulation; improving market access; promoting the right vehicles and structures for asset management; establishing an optimal tax environment (including various levies) for investors; expanding infrastructure in a targeted manner and providing specific training (Source:

SBA and SFAMA). The greatest impairment identified in the funds business is still the fact that the access to the EU market is restricted. In the past these restrictions concerned only the UCIT-industry. However, these restrictions are expanding to the Swiss alternative investment funds industry due to the AIFM Directive.

The effects of the Directive are still being heavily discussed not only in the EU, but also in Switzerland, as the regulatory details of the implementing laws regarding the Directive are becoming known. During the initial phase of the Directive, ie, until July 2015, Swiss investment managers will have to rely on the laws of the EU member states for distribution of their non-EU funds and will have to implement an EU AIFM for their EU funds, thereby relying on delegation of duties to their Swiss investment manager. Furthermore, the FINMA has meanwhile concluded a large number of co-operation agreements with various EU member states on the basis of the ESMA-approved standard agreement, which is the basis for the approval of Swiss investment managers non-EU AIFM.

From a Swiss point of view it remains to be seen whether hedge fund managers will prefer Switzerland's strengths as a business centre, relying on the private placement regimes of the individual member states, or whether they will deem EU authorisation as being advantageous when talking to their EU investors. To be in line with international developments, in particular the implementation of the Directive, the Swiss Collective Investment Schemes Act (CISA) has been revised with effect from 1 March 2013 to adjust the legal provisions for the managers of collective capital investment assets. At the same time, the rules on the distribution to qualified investors have been tightened, requiring many foreign hedge funds to seek approval for distribution.

2. REGULATIONS GOVERNING HEDGE FUNDS AND ONSHORE MANAGERS

2.1 Domestic hedge funds

2.1.1 Types of domestic funds available for alternative investments

Domestic hedge funds are governed by the CISA. This law provides for a choice between four different structures for alternative investments, two open-ended structures and two closed-ended structures. While the closed-ended limited partnership for collective investments is by law restricted to qualified investors (with the exception of high-net-worth individuals who have to formally declare to want to be considered qualified investors), the other three types of structures can be limited to qualified investors according to their fund regulations or articles of association. Collective investment schemes restricted exclusively to qualified investors may be fully or partially exempt from certain provisions of the CISA, provided that the purpose of investor protection guiding the provisions within the CISA is not impaired.

(a) Contractual investment funds

Contractual investment funds are open-ended investment structures which, according to the CISA, entitle investors directly or indirectly to redeem

their units at the net asset value and at the expense of the collective assets and were the only type of fund structure accepted in Switzerland under the previous investment fund Act before the amendment of CISA in 2007. The relationship is governed by a tripartite fund contract between the investors on the one hand and the fund management company as well as the custodian bank on the other hand. A second agreement, the custody agreement, is concluded between the fund management company and the custodian bank. Both the fund management company and the custodian bank must have their domicile in Switzerland and must be authorised by the FINMA. The fund contract and any amendments thereto require FINMA approval.

(b) SICAV

The SICAV is an open-ended corporate structure with a variable capital base. This allows the investors to redeem their units at the cost of the collective assets at net asset value.

The SICAV can be established as an umbrella fund with segregated sub-funds. The management of the SICAV can be maintained either in-house (self-managed SICAV) or may be outsourced to an external fund management company approved by the FINMA.

The SICAV has two classes of shares, being the company shareholders, who act as promoters of the vehicle and have funded the initial share capital at the time of incorporation, and the investor shareholders who hold ordinary shares. The initial investment amount is CHF 250,000 in the case of an outsourced fund management and CHF 500,000 in the case of a self-managed SICAV.

(c) Limited partnership for collective investments (LPCI)

The limited partnership for collective investments (LPCI) mirrors the limited partnership as commonly used in offshore hedge fund jurisdictions. Accordingly, it is set up with a general partner bearing unlimited liability and at least five limited partners. The general partner is required to be domiciled in Switzerland and must be a company limited by shares. It may only fulfil this function for one LPCI. The limited partners must be qualified investors.

The LPCI is a closed-ended structure with a fixed capital base. It was created more for private equity investments than for hedge fund structures. However, hedge funds specialising in illiquid assets may find this structure just as interesting. The latest revision of the CISA also clarifies the possibility for LPCI to invest in real estate and infrastructure projects.

(d) SICAF

The SICAF is the closed-ended corporation with a fixed capital base, split into a fixed number of shares with a par value. Therefore redemptions of shares are not possible. Contrary to the other structures set out above, which are exclusively governed by the CISA, the SICAF is governed by the Swiss Code of Obligations to the extent that the CISA does not provide otherwise.

The SICAF is not subject to approval and is not governed by CISA at all if it is either quoted on a recognised Swiss stock exchange or if the investors are limited to qualified investors.

2.1.2 Regulation of domestic funds
In order to obtain FINMA's approval, all domestic and foreign hedge funds that aim to obtain an authorisation for distribution are required to provide the following documentation:
- investment funds: the collective investment contract;
- SICAVs: the articles of association and investment regulations;
- limited partnerships for collective investment: the company agreement;
- SICAFs: the articles of association and investment regulations;
- foreign collective investment schemes: the relevant documents.

Furthermore, if a contractual investment fund or SICAV is structured as an open-ended collective investment scheme with sub-funds, each-subfund or category of shares requires individual approval.

2.1.3 Investment restrictions
CISA has provided for a specific and very flexible set of rules for the investment techniques and restrictions applicable to alternative investment vehicles. In particular, a fund for alternative investments may enter into credit facilities of up to 50% of the net assets and overall leverage exposure may reach up to 600% of the fund's net assets. Up to 100% of the fund's assets may be pledged.

2.2 Foreign hedge funds
2.2.1 Distribution vs private placement
Foreign hedge funds can only be distributed in or from Switzerland if they have received prior approval by the FINMA. Foreign hedge funds offering exclusively to certain categories of investors are not subject to approval in Switzerland. As shown above most hedge funds placed in Switzerland have not been offered to the public according to the old CISA and therefore did not need prior approval from FINMA.

2.2.2 New rules for distribution
The CISA has recently been amended and its revised version came into force on 1 March 2013 together with a revised version of the Ordinance on Collective Investment Schemes (CISO).

Both, the revised CISA and CISO contain new rules governing the distribution of foreign collective investment schemes in Switzerland. Key aspects of the new rules are set out below.

Under the new rules the concept of 'public distribution' has been replaced. No requirements must be satisfied if the placement of collective investment schemes, whether foreign or Swiss, does not constitute a 'distribution'. Basically all kinds of offering or advertisement of collective investment schemes whether foreign or Swiss, will be considered as a distribution under the new CISA, unless such offering or advertisement is made:

- exclusively to a regulated financial institution, such as a bank, securities dealer, fund management company, asset manager of collective investment schemes or central bank (regulated financial institution) or a regulated insurance institution;
- on the basis of a strict reverse solicitation;
- by a regulated financial institution on the basis of a written asset management agreement;
- by an independent asset manager to its client on the basis of a written asset management agreement, provided that the independent asset manager is subject: (i) as financial intermediary, to the Swiss laws on anti-money laundering; and (ii) to the recognised conduct of business rules of an organisation in the financial sector, and the asset management agreement is in compliance with the recognised standards of the aforementioned organisation.

Further, publication by regulated financial intermediaries of current prices, net asset values and tax data does not constitute a distribution of collective investment schemes, provided that such publication does not include any contact details. Finally, the revised CISA exempts to a certain extent the offering of participation plans to employees through collective investment schemes.

2.2.3 Requirements for authorisation for public distribution

If foreign collective investment schemes will (also) be distributed to non-qualified investors in or from Switzerland, both the distributor and the foreign collective investment schemes must be authorised by the FINMA, and a Swiss representative and paying agent must be appointed. In this case, the following will apply:

- in the country of domicile the hedge fund has to be subject to public supervision protecting the investor;
- the supervision of the management company has to be equivalent to the protection granted by Swiss law with respect to organisation, investor rights and investment policy;
- the designation of the fund must not be misleading. In particular, it must be consistent with the investment policy actually pursued.
- a licensed representative and a licensed Swiss bank acting as paying agent in Switzerland for the units distributed in or from Switzerland must be appointed;
- there must be cooperation arrangements which include the exchange of information, cross-border on-site visits and mutual assistance in the enforcement of the respective supervisory laws have to be in force between FINMA and the foreign authority.

In fact, in March 2013 the European Securities and Markets Authority (ESMA) approved the first level of cooperation arrangements between the FINMA and the EU securities regulators for the supervision of alternative investment funds, including hedge funds, private equity and real estate funds. ESMA negotiated the agreement with FINMA on behalf of all 27 EU national competent authorities for securities markets regulation.

Foreign hedge funds which are distributed only to qualified investors do not need approval from FINMA, but only to appoint a Swiss representative and paying agent. Nevertheless the distributor will usually need an authorisation.

2.2.4 Who will be treated as a qualified investor?

To avoid submitting the hedge funds to approval it will be necessary to limit distribution to qualified investors only. As of 1 June 2013, the following entities will be treated as qualified investors by operation of law:

- regulated financial institutions and regulated insurance institutions;
- public entities and retirement benefits institutions with professional treasury operations;
- companies with professional treasury operations.

Further, certain individual investors have the right to opt in or opt out, respectively:

- an investor who has concluded a written management agreement with a recognised independent asset manager or a regulated financial institution will be deemed to be a qualified investor, provided that it does not declare that it wants to be treated as a non-qualified investor (opting out). The investor must be informed of its status as qualified investor, the risks involved, and its right to opt out before 1 June 2013;
- a high-net-worth individual (who does not fall within the above-mentioned category) may declare in writing that it wants to be treated as a qualified investor (opting in), provided that it: (i) may demonstrate the knowledge necessary to understand the risks in connection with the investment based on individual education, professional experience or similar experience in the financial sector, and that it possesses bankable assets of at least CHF 500,000; or (ii) confirms in writing and demonstrates that it possesses financial assets of at least CHF 5 million. These are higher standards than those under the current legal regime, which require financial assets of (only) CHF 2 million, but no proof of market knowledge. As of 1 March 2015, persons that are deemed high-net-worth individuals under the existing CISA, which do not meet the above requirements, may no longer enter into investments in collective investment schemes available to qualified investors only.

2.3 Fund managers

2.3.1 Terminology

Under Swiss law, fund managers are referred to as asset managers to avoid confusion with fund management companies, which deal with the overall management of the fund, including the fund administration. The fund management company may (but does not have to) outsource the asset management to an external fund or asset manager, being a corporation or an individual person. In the event of such delegation the fund management can only appoint persons who are properly qualified to undertake the tasks assigned to them and is responsible for meeting the necessary measures for instruction and monitoring of the implementation.

In the context of this article, the term 'fund managers' is used as synonym for the investment or asset manager as entity, while the term fund management company is used for the entity responsible for the overall management of the fund, including all administrative tasks, such as accounting, NAV-calculation, determination of issue and redemption prices, filing tax returns for the fund, etc. The individual partner of the fund manager is referred to as the principal of the fund manager.

The fund management company and the asset manager's general authorisation is granted, if the following can be proven:

(a) persons responsible for management and business operations
  - have a good reputation;
  - guarantee proper management; and
  - possess the requisite professional qualifications;

(b) the significant equity holders (ie, holding 10% or more of the equity)
  - have a good reputation; and
  - do not exert their influence to the detriment of prudent and sound business practice;

(c) internal regulations and appropriate organisational structures ensure compliance;

(d) sufficient financial guarantees are available;

(e) to the extent the FINMA makes this a condition for its granting of authorisation, compliance with the code of conduct of the relevant industry body.

2.3.2 Swiss fund managers

Fund managers domiciled in Switzerland currently must seek the FINMA's authorisation if they manage funds in or from Switzerland.

Previously only asset managers of Swiss collective investment schemes had to be authorised. Swiss fund managers of foreign collective investment schemes could apply for an authorisation on a voluntary basis if this was required under the applicable foreign jurisdiction and provided the foreign fund was subject to adequate supervision in the country of origin.

The recent amendments to CISA and CISO establish that both Swiss and foreign asset managers of collective investment schemes must apply for an authorisation.

However this requirement is mitigated by CISA providing for certain exceptions, which apply if: (a) the subscribers of the funds managed by such asset managers are exclusively qualified investors and all collective investments managed by that asset manager do not exceed CHF 100m or, without leverage CHF 500m; or (b) if the investors in the fund managed by the asset manager are affiliates within the asset manager's group of companies. On the other hand, asset managers who are not in the scope of CISA due to these *de minimis* exemptions may be authorised by FINMA on a voluntary base if the collective investment scheme's country of domicile or distribution requires it.

2.3.3 Foreign fund managers

The fund management company may delegate the asset management to a foreign fund manager provided the latter is subject to adequate supervision in its country of origin and is sufficiently qualified to conduct its investment management mandate properly. Furthermore, under the new CISA, it will be necessary to prove the existence of an agreement for co-operation and exchange of information between FINMA and the relevant foreign supervisory authorities, if such agreement is required by foreign law.

The new CISA allows a foreign asset manager to establish a Swiss branch, which can be authorised, subject to adequate supervision of the head company, adequate organisation, financial resources and competent employees of the branch in Switzerland and the existence of a co-operation and exchange of information agreement between FINMA and the foreign asset manager's home regulator.

3. TAXATION

3.1 General remarks

3.1.1 Overview over Swiss tax regime

The Swiss tax system has three different levels of taxation: federal, cantonal and communal. The federal and cantonal levels all have their own tax authorities and their set of rules, if largely harmonised. In addition, every commune sets its own tax rate. Tax planning therefore also includes the choice of residence within Switzerland. Geneva, despite comparatively high tax rates, currently appears to be the heart of the hedge fund industry.

The corporate profit tax rates depend on the canton and range from around 13% to 32%. The corporate tax rate in Geneva is 24%. In addition, a corporate capital tax of 0.001 to 0.5% applies. All cantons are presently able to grant additional tax privileges for companies obtaining the majority of their income from activities abroad.

Swiss individual tax rates are progressive and the differences among the cantons are substantial. While the top income rates in certain cantons are as low as approximately 19%, they can be as high as 45% (eg, Geneva) in others. On top of that, there is a compulsory state pension plan, which is not capped. The contributions amount to approximately 6% for employees and 11% for self-employed persons. In addition to this, there is a wealth tax levied of approximately 0.1-1%.

At present, most cantons still grant lump sum taxation to non-Swiss nationals taking up residence in Switzerland, provided they have not had residency in Switzerland at any time during the last 10 years. The lump sum taxation essentially allows individuals to be taxed on their expenditure in Switzerland, usually calculated on five (respectively, as per 2016, seven) times the annual rent of their accommodation in Switzerland. However, the taxation basis may not be lower than the income from Swiss sources as well as certain other items of income, including treaty-favoured income. Individuals under a lump sum taxation must refrain from all gainful activities in Switzerland. At present the lump sum taxation is under discussion in Switzerland and the Cantons of Appenzell Ausser Rhoden,

Basel-City, Basel-Land, Schaffhausen and Zurich actually abolished it recently.

3.1.2 Use of offshore jurisdictions in fund structures in general

In most hedge fund structures, the fund management company or the fund itself are domiciled in a foreign offshore jurisdiction and the fund manager may or may not be offshore. This has both tax and regulatory implications in Switzerland.

Both the federal and cantonal tax administrations, as well as the FINMA, are prepared to give advance rulings on the recognition of the offshore structure, if the full facts regarding the type and extent of management activities are disclosed to them. This allows players to gain pre-approval for their structure, thus eliminating the risk of being qualified as a Swiss collective investment scheme post factum.

(a) Tax aspect

From a tax point of view it is important that effective management of the companies domiciled offshore is not done in Switzerland. The Swiss tax administrations have developed certain criteria to define whether a fund is effectively managed out of Switzerland or from abroad:

(a) the purpose of the offshore company should be specific;
(b) the offshore company actually employs qualified staff and has rented adequate office space in the offshore jurisdiction (criterion of substance);
(c) no part of the day-to-day management of the offshore company is undertaken from Switzerland;
(d) Swiss residents preferably should not hold offices in the offshore company, or should by all means be in the minority with other officers also taking an active role in the decision-making process;
(e) bank accounts should ideally be in the jurisdiction of the offshore company's jurisdiction; and
(f) Swiss residents should not have signatory powers on the bank accounts and should also not have means of indirect access, eg, electronic banking.

In the past, Swiss tax authorities successfully disregarded offshore structures on grounds of their having been implemented for mere tax planning purposes. Therefore it is advisable to substantiate the economic or legal justification for the use of the offshore structure.

(b) Regulatory aspect

Similarly, the Swiss regulator will consider an offshore fund as being a Swiss fund if the place of main management is in Switzerland. Pursuant to Article 42 CISO (being the ordinance relating to the CISA), the Swiss regulator considers the following to be the main management of a fund:

(a) the unalienable duties of the directors of a Swiss corporation, being:
    1. the ultimate management of the company and the issuing of the necessary directives;
    2. the establishment of the organisation;

3. the structuring of the accounting system and of the financial control as well as the financial planning insofar as this is necessary to manage the company;
4. the appointment and removal of the persons entrusted with the management and the representation;
5. the ultimate supervision of the persons entrusted with the management, in particular, in view of compliance with the law, the articles of incorporation, regulations, and directives;
6. the preparation of the business report as well as the preparation of the shareholders' meeting and the implementation of its resolutions; and
7. the notification of the judge in case of over-indebtedness;

(b) the following duties of a Swiss fund would have to be performed in Switzerland and may not be performed in Switzerland by a foreign fund:
1. the decision on the issuance of units;
2. the decision on the investment policy and asset valuation;
3. the asset valuation;
4. fixing of the issuance and redemption price;
5. determination of the distribution of profits;
6. determination of the contents of the prospectus, the annual or semi-annual reports as well as of further investors' publications; and
7. accounting.

Provided that none of the above activities are exercised in Switzerland, the Swiss regulator will accept the management of the foreign fund as being abroad.

3.2 Basic principles of taxation

When looking into taxation there are various tax principles which apply and which can be combined in an 'open architecture' to create the best tax structure for the hedge fund and the principals of the fund manager. The following can only provide a very general overview over certain basic principles of taxation.

3.2.1 Taxation of hedge funds domiciled in Switzerland

From a tax point of view the various types of funds can be classified in two groups: (i) the SICAV, the contractual fund and the LPCI which are tax transparent unless they hold real estate ('partially tax transparent'); and (ii) the SICAF, which is treated identically to any other corporation in Switzerland and therefore is not tax transparent for any type of taxes.

(a) Income/profit taxation

The partially tax transparent structures are treated tax transparent for the purpose of income or profit taxation as long as they do not directly own real estate.

(b) Stamp tax

For the purpose of stamp tax the partially transparent vehicles do not qualify

as securities dealers and therefore are stamp tax exempt. SICAFs are subject to stamp tax.

(c) Withholding tax (WHT)

WHT treatment of partially transparent vehicles depends on whether they are accumulating or distributing funds. If accumulating, they are subject to WHT on net profits but not on capital gains and, if they are distributing funds, WHT will be levied on effective distributions. Funds with a mixed policy of accumulation and distribution are treated separately. Distributions of accumulating funds are only subject to WHT to the extent that the profits have not already been taxed during the accumulation period. Special rules apply to profits derived by the fund from direct ownership of real estate.

SICAFs are subject to WHT. The tax is levied on the profits distributed to the investors.

Special rules apply to funds of funds domiciled in Switzerland. The principle is to create full transparency over all levels of the funds which the fund of funds is invested into, with a final taxation at fund of funds level. However, this principle is not applied in the event that the following criteria are all met by the fund of funds:

(a) the fund of funds is a Swiss partially transparent fund;
(b) the documentation of the fund of funds shows beyond doubt that the investment strategy is to achieve capital gains (achieving net profits excluding capital gains of less than 2% of its NAV); and
(c) the fund of funds provides an annual aggregate overview over the *pro rata* investments of the various funds it was invested in.

3.2.2 Taxation of corporations domiciled in Switzerland

(a) Remuneration on cost-plus basis

Assuming that the Swiss-based corporation will only be holding an advisory role fulfilling auxiliary functions (as was the rule in the past) and all fund management (including investment management) activities remained offshore, the advisor could be remunerated on a cost-plus basis. The value to be added to the costs will be between 5% and 20%, depending on the level of services performed by the Swiss company.

(b) Receipt of management and performance fees

Performance and management fees received by a Swiss corporation qualify as taxable profits. In the context of determining the profit of the Swiss company, the tax administrations will, in particular, review whether the internal transfer prices between the Swiss and non-Swiss companies, as well as the income paid out to the principals of the fund manager is at arm's length and whether the costs of the various companies are in an acceptable relation to the profits of that company.

3.2.3 Taxation of individuals

(a) Permanent foreign establishment of a Swiss tax resident

Under Swiss law (unilateral exemption and no tax treaty required) a Swiss

tax resident individual actually working abroad a substantial part of his time and having offices in a foreign jurisdiction is deemed to have a permanent establishment abroad. The profits attributable to this permanent foreign establishment are tax exempt. This requires an allocation of profits between Switzerland (where the individual will have taxable profits) and abroad, the foreign income usually being 20%-50%. Rulings can be negotiated with the cantonal tax authorities to fix the exact deemed income allocated abroad.

(b) Taxation of performance fees and carried interest

In 2008 the Federal Tax Administration drafted a circular on the taxation of distributions to the individual hedge fund and private equity managers resident in Switzerland. This draft was based on lengthy discussions among the various stakeholders in order to obtain a more favourable tax regime with respect to the carried interest and the performance fee. Although according to informal information it would seem that the draft will not be published anytime soon, a number of cantons follow the practice set forth in the draft. It is recommended that the setting up of a structure be discussed in advance with the tax authorities.

The draft does not provide for a special tax exemption for fund managers, but clarifies certain taxation issues relating to distributions based on the ordinary rules applicable to all taxpayers in Switzerland.

The draft distinguishes between ‘performance fee' in the case of hedge fund managers and ‘carried interest' in the case of private equity. Both terms apply to payments which, according to the tax authorities, qualify as disproportionate returns. If, however, the return on equity payable to the fund manager or the principals of the fund manager is proportionate to the ordinary investors return on equity, this qualifies as a capital gain.

In the cantons following the rules of the draft circular, the principals of the fund managers are generally taxed as follows:

(a) provided the performance fee (or carried interest as the case may be) is received by and booked with the Swiss or foreign fund manager the following applies:
- the participation in the fund manager held by the principal qualifies as private asset. Thus all capital gains resulting from the sale of participations in the Swiss/foreign corporation are tax free, subject to the rules relating to indirect partial liquidation and transposition *(transponierung)*;
- all arm's length payments made to the principal as remuneration for his activity as employee of the Swiss or foreign corporation operating as fund manager qualify as salary and are taxable income. Likewise a performance-based bonus, which is due under the employment contract is taxable income; and
- dividends received from the Swiss or foreign corporation operating as fund manager qualify as taxable income. However, for participations of more than 10% the cantons provide for a reduced taxation;

(b) if the fund management is done by the principal personally (and not

through a corporation) or through an LLP in which the principal has a participation, the principal is entitled to receive the carried interest, as well as the management fees. Taxation will follow the following principles:

- the participation in the LLP qualifies as a business asset;
- capital gains, management fee and carried interest qualify as income from independent gainful activity; and
- distributions of capital gains by a transparent fund managed by a third party and held as private asset qualify as tax free capital gains (distribution of income will be taxable, however).

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