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June 27, 2019

TECHNICAL NOTE—REGULATION AND SUPERVISION OF ASSET MANAGEMENT ACTIVITIES

This Technical Note on Regulation and Supervision of Asset Management Activities for the Switzerland FSAP was prepared by a staff team of the International Monetary Fund as background documentation for the periodic consultation with the member country. It is based on the information available at the time it was completed in May 2019.

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TECHNICAL NOTE

REGULATION AND SUPERVISION OF ASSET MANAGEMENT ACTIVITIES

Prepared By
Monetary and Capital Markets Department

This Technical Note was prepared by IMF staff in the context of the Financial Sector Assessment Program in Switzerland. It contains technical analysis and detailed information underpinning the FSAP's findings and recommendations. Further information on the FSAP can be found at http://www.imf.org/external/np/fsap/fssa.aspx

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Glossary

AuM	Asset under Management
BCBS	Basel Committee on Banking Supervision
CHF	Swiss francs
CIS	Collective Investment Scheme
CISA	Collective Investment Schemes Act
CISO	Collective Investment Schemes Ordinance
ECB	European Central Bank
FDF	Federal Department of Finance
ETF	Exchange-Traded Fund
FinIA	Financial Institution Act
FinSA	Financial Services Act
FINMA	Swiss Financial Market Supervisory Authority
FMIA	Financial Market Infrastructure Act
FMIO	Financial Market Infrastructure Ordinance
FSAP	Financial Sector Assessment Program
FSB	Financial Stability Board
FTE	Full Time Equivalent
IM	Initial Margin
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
L-QIF	Limited Qualified Investor Fund
MMFs	Money Market Funds
MoU	Memorandum of Understanding
NAV	Net Asset Value
OTC	Over-the-Counter
SNB	Swiss National Bank
SFAMA	Swiss Funds and Asset Management Association
SIF	State Secretariat for International Financial Matters
VM	Variation Margin

EXECUTIVE SUMMARY

Since the 2014 FSAP, the Swiss Financial Market Supervisory Authority (FINMA) has enhanced the intensity of supervision of the asset management and fund industry, but work remains to be done. FINMA utilizes a range of supervisory tools, has introduced a new "offsite inspections" program, and has significantly increased onsite inspections. FINMA has also enhanced its enforcement policy, taken targeted actions against individuals, and increased public disclosure of individual enforcement cases. In close cooperation with foreign supervisors, FINMA has enhanced the supervisory intensity of groups. The supervision of asset management activities would benefit from better monitoring of concentration risks, closing regulatory gaps, more granular data and enhanced analytical capacity, introducing administrative fines, and greater enforcement resources.

Swiss funds and foreign funds distributed in Switzerland reached over 1 trillion Swiss francs (CHF) (160 percent of GDP) at end-2017. Due to definitional differences, however, not every activity is covered by official statistics; industry associations suggest that the sector could be as high as CHF 2 trillion. Positive market performance of equity and bond funds, and inflows of new investments are important contributors to the recent growth. Since 2013, leverage levels have been low and stable for equity and bond funds, and the assets under management (AuM) of money market funds (MMFs) have increased slightly. Constant net asset value (NAV) per share MMFs (C-NAV MMFs) are not allowed in Switzerland, although Swiss asset managers are managing some foreign domiciled C-NAV MMFs.

Concentration risk should be better monitored to prevent undue concentration. While most Swiss funds are subject to concentration limits for their investments (such as 10 percent per single entity), higher concentration limits are applied to counterparty credit risks through certain derivative transactions (such as, total return swaps for index funds). Concentration risk (such as via exchange-traded funds' (ETFs) swap counterparties) warrant heightened supervision, and potentially regulation. The concentration of group exposures between group custodian banks and ETFs may trigger runs when a group comes under stress.

FINMA should continue to enhance its cooperation with foreign supervisors to monitor and supervise effectively internationally active asset managers. FINMA's latest semi-annual Risk Barometer identified increased liquidity risks in the asset management industry. Publicly available data and large Swiss asset managers' latest disclosures also show that some funds, particularly those focusing on underperforming asset classes (such as bonds), have suffered from material outflows, especially in the fourth quarter of 2018. Recent experience with a large and internationally active manager underscores that group supervision is important for large and complex asset management groups. FINMA's recent decision to expand its supervisory scope beyond its regulated entities is welcome.

FINMA should update its IT systems and address data gaps to improve its analytical capacity and ability to conduct industry wide liquidity stress tests. The IT system does not support easy analysis, such as comparing supervised funds with the industry average. Moreover, in addition to a lack of data due to regulatory gaps, the official reporting template is not granular enough. Data

gaps compromise quantitative and detailed analysis of important risks (such as liquidity and maturity mismatches and the level of leverage) at both the firm and industry levels. While asset managers' risk management systems, including for liquidity risks, are important to prevent idiosyncratic incidents, these do not capture sector-wide risks, such as undue concentration. IT systems and data collection will become more important when a significant number of independent asset managers come under FINMA's indirect supervision in 2020.

FINMA should have the power to impose administrative fines. While FINMA can seize profits resulting from serious regulatory violations and revoke the violator's license, FINMA cannot impose administrative fines. This limitation could pose important challenges to FINMA, particularly when it starts supervising a significant number of small independent asset managers. In addition, within the current legal constraints, FINMA should use its existing enforcement tools more actively and comprehensively disclose individual enforcement actions and license revocations.

Table 1. Switzerland: Key Recommendations

#	Recommendations and Responsible Authorities	Timing*	Priority**
1	Increase the coverage and granularity of data reporting requirements (FINMA; paragraphs: 13–14).	ST	H
2	Conduct industry-wide liquidity stress tests of the asset management and the fund industry (FINMA; SNB; paragraph:16).	MT	M
3	Update FINMA's IT system to improve its analytical capacity (FINMA; paragraphs:12 and 15).	MT	M
4	Empower FINMA to impose administrative fines (FDF; paragraphs: 40–41).	MT	M
5	Monitor concentration risk of regulated funds and prevent undue concentration (FINMA; paragraphs: 21–23).	ST	H
6	Enhance international cooperation with foreign supervisors on internationally active asset managers (FINMA; paragraph: 8).	ST	H
7	Subject limited qualified investment funds to intensive monitoring of the key risks (size, leverage) and proper risk management requirements through asset managers (FDF, FINMA; paragraph: 35).	MT	M
8	Closely monitor the effectiveness of valuation safeguards to address potential conflict of interests within a banking group (FINMA; paragraphs: 26–27).	ST	M

* C = Continuous; I = Immediate (within one year); ST = Short Term (within 1–2 years); MT = Medium Term (within 3–5 years)

** H= High; M= Medium; L=Low.

INTRODUCTION

1. **This note includes a focused review of the effectiveness of the regulation and supervision of asset management activities.** The note is part of the 2019 FSAP, drawing on discussions in Switzerland from October 31 to November 14, 2018, and from January 23 to February 6, 2019. The note covers both regulated and unregulated entities and was prepared by Nobuyasu Sugimoto (IMF, Monetary and Capital Markets Department).

2. **This review focuses on the aspects of the regulation and supervision of the asset management and fund (collective investment schemes (CIS)) industries that are most relevant for systemic risk to the Swiss financial sector.** This area has witnessed material supervisory and regulatory changes since the last FSAP. In June 2018, Parliament approved revisions to the Financial Services Act (FinSA) and Financial Institution Act (FinIA), which will enter into force in January 2020. FinIA introduces a comprehensive regulatory framework for independent asset managers by bringing a multitude of small independent asset managers within the regulatory perimeter (see paragraph 16 for details). The FinSA sets out cross-sector rules for the offer and distribution of financial services and financial instruments, including funds.

3. **This analysis is based on various information sources.** These include the authorities' response to a questionnaire and self-assessment of 17 International Organization of Securities Commissions (IOSCO) Principles,[1] a limited review of the relevant legal and regulatory framework, and discussions with the authorities, self-regulatory bodies, and market participants.

4. **The author is grateful to the authorities and private sector participants for their excellent cooperation**. The analysis has benefitted greatly from the inputs and views expressed during the discussions with government officials, financial regulators, supervisors, asset managers, industry associations, academia, and professional organizations.

MARKET DEVELOPMENT

5. **Due to the limited scope of this review, market analysis focused on the asset management and fund industry.** Official reporting does not cover the entire asset management and fund industry in Switzerland, depending on the definition used. This is partly due to the lack of current regulations for independent asset managers responsible for clients' assets under discretionary mandates. Detailed official data is only available for CISs approved by FINMA under Swiss law and foreign funds approved for distribution in Switzerland.

6. **The Swiss funds and foreign funds distributed in Switzerland reached CHF 1,087 billion (160 percent of GDP) at end-2017, a year-over-year increase of 17.7 percent** (Table 2). Equity

[1] 17 principles were initially selected in early 2018, and the authorities submitted responses which cover the principles 1, 2 3, 4, 6, 7, 9, 10, 11, 12, 15, 16, 29, 30, 31, 32, and 37. However, asset management and fund industry has faced some impact due to higher volatility of the capital markets later in 2018. Therefore, an additional questionnaire focusing on prudential regulation and supervision of the asset management and fund industry was submitted to the authorities and useful responses were provided by the authorities within a very short period.

funds grew in 2017 mainly due to the positive market performance; bond funds grew due to both market appreciation and higher inflows. Other funds suffered outflows and market depreciation, although the impact on the market size was negligible. Constant net asset value per share MMFs (C-NAV MMFs) are not allowed in Switzerland, although Swiss asset managers are managing some foreign domiciled C-NAV MMFs.

Table 2. Switzerland: AuM of Swiss Fund Markets

(In CHF billion)

AuM of Swiss fund markets reached over CHF 1 trillion in 2017.

Fund category	Volumes end-2016	Volumes end-2017	Inflows/ outflows in 2017	Market performance-related changes in 2017
Equity funds	380.8	465.8	1.6	83.4
Bond funds	288.8	339.0	30.2	20.0
Asset allocation funds	108.5	128.6	4.2	15.9
Money market funds	71.6	74.3	-0.5	3.2
Real estate funds	32.0	32.8	-0.3	1.1
Commodity funds	19.8	23.0	2.0	1.2
Alternative investments	18.5	20.7	-0.1	2.3
Other funds	3.1	2.7	-0.3	-0.1
Total Swiss market	**923.1**	**1,086.9**	**36.8**	**127.0**

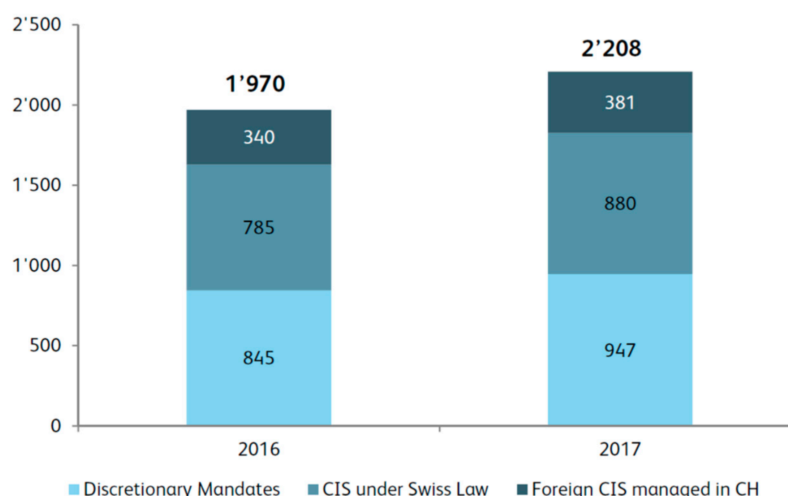
Sources: Swiss Funds and Asset Management Association (SFAMA) Annual Report, 2017.
Notes: The figures are based on the FINMA approvals list and cover all funds under Swiss law, except single-investor funds (Einanlegerfonds) and fund shares of all foreign funds distributed in Switzerland, including unit classes for qualified investors.

7. Assets managed under discretionary mandates are estimated to have reached over CHF 900 billion (134 percent of GDP; Figure 1). Currently, there is no regulation and supervision in place for independent asset managers managing client assets under discretionary mandates. Therefore, there is no reliable data about the size and performance of those asset managers; nor is there data on the type of underlying assets, leverage, and inflow and outflow of the AuM by independent asset managers. Lucerne University has estimated that assets managed under discretionary mandates reached over CHF 900 billion, with 12 percent annual growth, in 2017.[2] As noted above, these will be supervised starting in 2020.

[2] IFZ/AMP Asset Management Study, June 2018.

Figure 1. Switzerland: Assets Managed in Switzerland for Corporate and Institutional Investors

Assets managed under discretionary mandates account for about half of assets managed in Switzerland.



Sources: IFZ/AMP Asset Management Study, June 2018.

8. **FINMA should continue to enhance its cooperation with foreign supervisors to monitor and supervise effectively internationally active asset managers.** In the second half of 2018, some funds, including funds that focus on underperforming asset classes, such as emerging market bonds and commodities, suffered material outflows. These funds tend to have a relatively higher investment in illiquid instruments, such as exotic derivatives. Such outflows require prompt liquidation of these assets, which might have some negative market impact. One Switzerland-based large asset management group had to liquidate bond funds, although the funds were domiciled in Luxembourg, Ireland, and the Cayman Islands. These funds were managed by the group's foreign asset managers domiciled in the United Kingdom (U.K.) and Ireland; thus, FINMA did not have any direct supervisory powers over these troubled asset managers and the funds. This recent experience with a large and internationally active manager underscores that group supervision is important. FINMA's recent decision to expand its supervisory scope beyond its regulated entities is welcome.

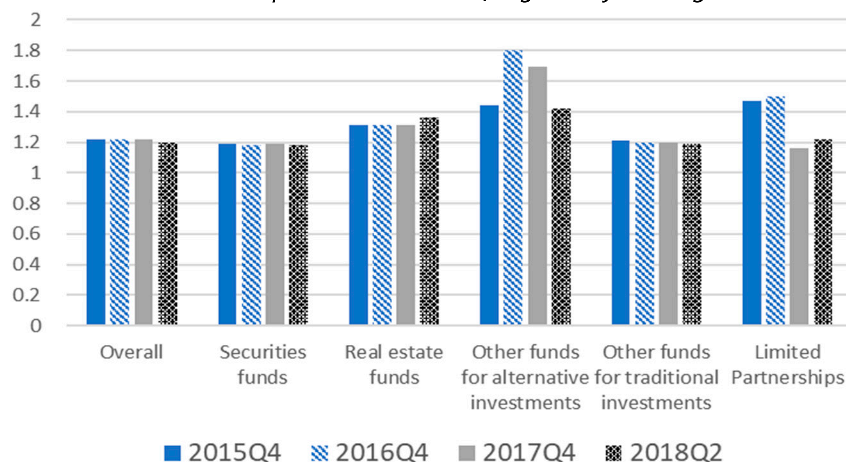
9. **The leverage of Swiss regulated funds is low and stable** (Figure 2). The leverage level is monitored by the authorities via ad-hoc supervisory data collection and since 2018 with official statistics.[3] The overall leverage level has been stable and low in the last few years, including for alternative investment funds (some of them are "hedge funds"). Derivative positions are converted to underlying assets with appropriate sensitivity (such as deltas for equity derivatives and notional amount for credit default swaps' credit long positions), taking account of permissible netting and hedging. Securities financing transactions are also considered if the reinvestment of collateral generates a return in excess of the risk-free interest rate. Use of the Value at Risk method is allowed upon FINMA approval and is granted only to a few funds.

[3] The FINMA ordinance on collective investment schemes specifies in detail the definition of leverage.

Figure 2. Switzerland: Funds Gross Leverage

(Asset under Management/Net Asset Value)

The leverage level of funds is stable and low in the last few years, including those of alternative investment funds. The figures below are based on gross leverage (without considering admissible netting and hedging), and thus overstates the permissible level of regulatory leverage.



Sources: FINMA.

MAIN FINDINGS

A. Supervisory Resources and Capacity

10. FINMA is generally allocating sufficient staff to supervision—but not enforcement—of the asset management and fund industry.[4] At end-June 2018, 55 Full Time Equivalent (FTE) staff were allocated to the regulation and supervision of the asset management and fund industry, and 61 FTE to enforcement for the entire financial sector that FINMA is supervising. There was no indication of a resource shortage for supervision in general—except enforcement—based on the discussions with supervisors and industry participants, and a sample check of internal documentations. Feedback from market participants is quite positive about the quality and capability of FINMA staff in asset management and fund industry supervision. Several industry participants particularly highlighted the positive impact on the quality of supervision of the creation of the dedicated division (Asset Management (AM) Division) which was formerly part of the Market Division. Several market participants also noted a stronger commitment to better supervision by the current staff in the new AM Division. FINMA is also planning to increase its resources to cope with the additional workload of indirectly supervising a significant number of small independent asset managers from 2020.[5]

11. High turnover of FINMA staff has been improved gradually. During the last FSAP, FINMA was suffering from high turnover of staff (over 14 percent in 2011), especially the Market division (21 percent in 2011) where asset management and fund supervisors were lodged. In the last

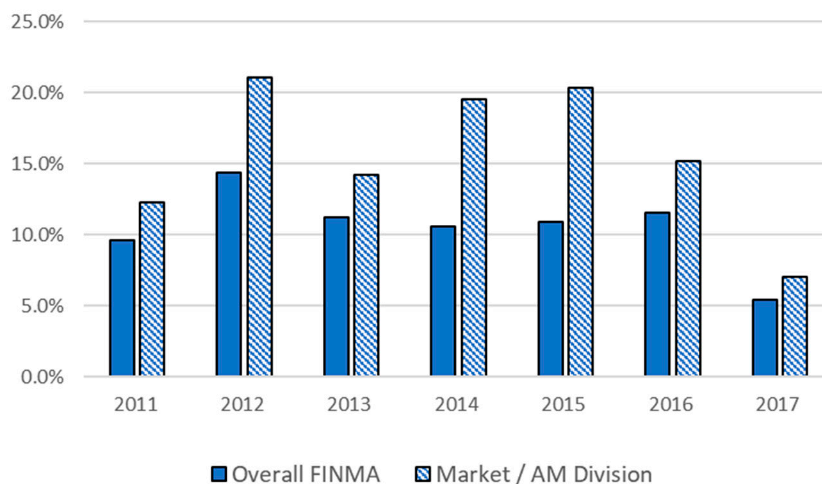
[4] Resource for enforcement is discussed later.

[5] FINMA intends to supervise the large number of small assets managers via a new independent supervisory organization, authorized by FINMA, that asset managers will be required to join.

five years, the overall turnover ratio has gradually reduced to low levels both overall for FINMA and for the asset management and fund supervision. FINMA is comfortable with the current level of turnover, as some inflow and renewal of expertise from new employees from within the financial industry helps FINMA to keep up with the rapid pace of change in the financial sector.

Figure 3. Switzerland: Trend of FINMA Turnover Ratio
(In percent)

Trend of FINMA staff turnover ratio has improved in the last five years. AM division was separated from the market division in 2014 so that the figures until 2014 are those of former Market Division.



Source: FINMA.

12. **However, there is room for improvement in the IT system and on data granularity to support FINMA's analytical capacity.** While supervisors receive several reports, including data from supervised entities and their auditors, these are reported only in paper format. While the early warning and alert system is mainly based on annual data collected by FINMA, and on the data from the quarterly Swiss National Bank (SNB) statistics, these are not granular enough for microprudential purposes. The FSAP welcomes FINMA's project to upgrade its internal IT system, which would introduce a unified online platform for collecting data and interacting with supervised entities (the platform "EHP"). The new platform will allow online submission of authorization applications.

13. **Particularly, the authorities are suffering from a lack of granularity in important data which covers the entire asset management and fund industry.** The SNB collects quarterly data from domestic regulated asset managers and funds on behalf of FINMA. However, the data is not granular enough to analyze several important risks, notably on credit (such as investment by credit ratings) and liquidity (such as investors' profile—wholesale or retail investors, and other information about liabilities) of the asset management and fund industry. Additionally, reporting does not cover foreign funds managed by Swiss regulated entities or distributed to Swiss investors. FINMA collects annually industry-wide information on asset management activities. Small independent asset managers (totaling an estimated AuM of up to CHF 500 billion) are, however unregulated until 2020; thus, their investment activities are not subject to any reporting requirement. FINMA is occasionally closing some data gaps by collecting and analyzing information on an individual entity basis.

14. Reporting requirements for the asset management and fund industry should be enhanced. The template should be revised to enable the authorities to analyze trends of key risk characteristics (such as credit risk taking, maturity and liquidity mismatches) more precisely. The coverage should also be expanded to other relevant players, including domestic asset managers managing foreign funds under the de-minimis threshold and foreign funds' distributing to Swiss investors, in close cooperation with relevant foreign supervisors as necessary.

15. FINMA should continue to improve its IT system and further enhance the analytical capacity of supervisors. The current IT system is in the process of being upgraded but there is still room for improvement. From 2020, a significant number of independent asset managers will come under FINMA's indirect supervision, which warrants a material upgrade of the IT system. FINMA is recommended to allocate sufficient budget resources to its IT system and further enhance the analytical capability of supervisors of the asset management and fund industry.

16. The authorities should also conduct industry-wide liquidity stress tests of the asset management and fund industry. Simple but industry-wide stress tests would help the authorities to identify the most critical data gap and concrete features of IT system more clearly. In addition, once granular reporting information with upgraded IT system become available, the authorities could be able to conduct more sophisticated industry-wide stress tests without undue additional cost. In the medium term, this would help the authorities identify and address risks in a forward-looking manner without material market impact.

B. Systemic Risk and Regulatory Perimeter

17. FINMA performs a semi-annual assessment of major macroeconomic capital market and structural risks (the "risk barometer"). The objective is to highlight key macro-financial risks and operational consequences which should be considered during supervisory activities. The report provides a very useful summary of macro-relevant risks in a forward-looking manner. The assessments and possible supervisory measures are reported to FINMA's Executive Board and are available to all supervision units within FINMA. FINMA also provides its systemic risk assessment to the SNB for its annual Financial Stability Report.

18. The early 2018 risk barometer highlighted a potential risk of liquidity pressure in the asset management and fund industry. The liquidity pressure had been initially felt in specific niche products and in a small number of funds, but later in 2018 became more wide-spread. This spurred supervisors to intensify supervision of liquidity management and needs. FINMA has also developed a specific real estate barometer to monitor the risks related to the Swiss real estate market.

19. The authorities adjust the regulatory perimeter when necessary. Currently, independent asset managers are not subject to prudential regulation and supervision. In June 2018, Parliament approved revisions of the FinIA and FinSA, which will enter into force in January 2020. FinIA includes licensing requirements and other prudential requirements (e.g., risk management, internal control, minimum capital and own funds) for independent asset managers. The implementation of the two acts will create uniform conditions for financial intermediaries and improve consumer protection.

20. The authorities are also actively contributing to a shadow banking exercise at the FSB. An inter-agency shadow banking analysis group has been established at the technical level involving SIF, FINMA, and the SNB. The group is mainly tasked with monitoring the potential risks of non-bank financial intermediation by analyzing the different data sources. Furthermore, the group is working to improve statistics, gather additional data on an ad-hoc basis, exchange information on an ongoing basis, and discuss summary of the analysis (such as heat maps) with respective management levels. A case study was provided to the FSB in 2014, focusing on the Swiss non-banking sector (including asset management and fund industry), and published as part of the "Global Shadow Banking Monitoring Report" in October 2014.

C. Selected Regulatory and Supervisory Issues

Concentration Limits

21. Funds are generally subject to concentration restrictions, except for funds for alternative investments. Securities funds and other funds for traditional investments may invest no more than a 10 percent in a single entity, and the total value of the securities in which more than 5 percent of the fund's assets are invested may not exceed 40 percent of the fund's assets. Real estate funds are also required to invest in more than ten properties and the market value of a single property may not exceed 25 percent of the fund's assets. An overall limit (20 percent of the total NAV) across different instruments (such as investments, deposits and claims) applies to the exposures of all entities within the same group in accordance with international accounting standards. Certain limits (such as 20 percent of the total NAV) also apply to the collateral of a single issuer. Alternative investments are not subject to those concentration restrictions.

22. However, such concentration limits may not be effective to address concentration of counterparty credit risk. Swiss funds are actively using over-the-counter (OTC) derivatives for hedging purposes (typically currency risk hedges for institutional investors). While similar concentration limits apply to OTC derivatives' counterparty exposures, these limits are relaxed for certain products (such as index funds). The limit also applies to their total NAV rather than the total OTC derivatives' counterparty exposures. As the result, these limits may not effectively require the funds to diversify their counterparties.

23. FINMA should monitor the concentration risk of regulated funds and prevent undue concentration. Funds managed by a banking group might tend to have significant concentration to their parent bank. As those positions are not always liquid and valuation requires a certain level of judgement, conflicts of interest need to be carefully managed. Moreover, these funds are vulnerable to run, reputation and contagion risk in case the parent bank faces financial stress. In fact, sample analysis suggests that some funds and ETFs managed by banking groups tend to have material concentration risk through derivatives.[6] International regulatory reforms have been implemented and have addressed this concentration to some extent (see Box 2). While the current size of such

[6] The latest Financial Stability Review by European Central Bank (ECB) also found high concentration and interconnectedness of synthetic ETFs. For more detail, refer to the chapter 3 of the report. https://www.ecb.europa.eu/pub/fsr/special/html/ecb.fsrart201811_3.en.html#toc6

exposures (after netting against collateral) may not be significant enough to pose systemic risk, it may create run risks and material conflict of interests in the event the parent bank faces market turmoil. Therefore, FINMA should prevent undue concentration and contagion between the asset management business and the banking business.

Box 1. Switzerland: Application of OTC Derivative Reforms to the Asset Management and Fund Industry

In March 2015, the Basel Committee on Banking Supervision (BCBS) and IOSCO finalized margin requirements for non-centrally cleared derivatives. The regulatory reform was initiated by the G20 in 2009 to reduce the systemic risk from OTC derivatives. As initially agreed in 2009, the G20's reform program comprised four elements: (i) all standardized OTC derivatives should be traded on exchanges or electronic platforms, where appropriate; (ii) all standardized OTC derivatives should be cleared through central counterparties; (iii) OTC derivatives contracts should be reported to trade repositories; and (iv) non-centrally cleared derivatives contracts should be subject to higher capital requirements. In 2011, the G20 agreed to add margin requirements on non-centrally cleared derivatives to the reform program.

Since 2015, Switzerland has enacted the Financial Market Infrastructure Act (FMIA) and the Financial Market Infrastructure Ordinance (FMIO), inter alia, to implement OTC derivatives reforms. The reforms, including margin requirements on non-centrally cleared derivatives, became effective in January 2016, with transition periods as laid out in the BCBS and IOSCO margin requirements. The FMIA and FMIO determine the conditions and compliance dates for financial and non-financial counterparties conducting OTC derivatives with regard to requirements of initial margin (IM) and variation margin (VM). Admissible collateral for IM and VM are specified by the FMIO, which includes cash deposits, government securities, etc.

According to the international standards, intra-group transactions may be exempted from the margin requirements. BCBS and IOSCO requirements allow national discretion on whether and how to apply the margin requirements to intra-group transactions. The international standards provide some background discussion, which states "some jurisdictions require inter-affiliate transactions to be subject to centralized risk management whereas others oblige affiliates to enter into transactions on an arm's length basis."

Similarly, the FMIA also grants an exemption from margin requirements for certain intra-group OTC derivatives transactions which meet four conditions. Those conditions are (i) the two counterparties are included in the same full consolidation basis; (ii) the two counterparties are subject to appropriate centralized risk evaluation, measurement and control procedures; (iii) there are no legal or factual impediments to the prompt transfer of own funds or the repayment of liabilities; and (iv) the transactions do not aim to circumvent the duty to exchange collateral.

Asset managers and funds generally do not qualify for the intra-group exemption and are therefore subject to IM and VM requirements. Even if the asset manager and funds are within a banking group, transactions with such funds are not recognized as "intra-group transactions" and thus not eligible for the exemption. While the transaction volume of small funds may qualify them for an exemption if it is under the applicable thresholds, large funds with material derivative exposures (such as synthetic exchange traded funds (ETFs)) are subject to IM and VM requirements.

IM and VM requirements mitigate group concentration risk to some extent. Collateral eligible for IM and VM are limited to cash, high quality bonds, covered bonds, shares of a major index, gold, MMFs, etc., In addition, collateral with wrong way risk (such as bonds issued by a parent bank or its competitors) are not allowed to be used as collateral. In this way, the concentration risk between a parent bank, the affiliate asset manager and its fund are mitigated to some extent.

Valuation of Assets

24. The net asset value (NAV) of all open-ended Swiss CISs is calculated at the market value on each day on which units are issued or redeemed. Investments that are listed on a stock exchange or another regulated market open to the public are valued at the price paid on the main market. Other investments for which no current price is available must be valued at the price that would probably be obtained in a diligent sale at the time of valuation. The SFAMA has established guidelines,[7] which have been recognized as minimum standards by FINMA. For real estate funds, the fund manager needs to appoint at least two natural persons or one legal person as independent valuation experts, subject to FINMA approval. The valuation experts must conduct their valuation with the due diligence and expertise required of a valuation expert. The valuation process and independence of external valuation experts for real estate funds was addressed in a specific thematic review in 2016. An additional thematic review has been conducted to address the implementation of changes in valuations of buildings under construction for real-estate funds.

25. Fund management companies, custodian banks, and auditors are required to ensure fair and reliable valuations. Fund management companies are responsible for a fair and reliable valuation through their obligation to ensure transparent financial statements. Custodian banks, too, must verify whether the calculation of the NAV of the issue and redemption prices of the units is compliant. An audit firm examines the funds' annual accounts.

26. FINMA should closely monitor the effectiveness of valuation safeguards to address potential conflict of interests within a banking group. Asset managers that belong to a banking group usually use the group custodian bank. Funds managed by banking groups tend to have material derivative positions on the parent banks. Depending on the product and strategy, significant derivatives are categorized as either level 2 or level 3,[8] thus valuation of those derivative positions are not readily available in the market. Moreover, valuation would become much more difficult to measure in a stressed market situation. Current regulation imposes several safeguards, such as separation of management between asset managers and custodian banks. However, the asset management business has grown and is a very important revenue source even for a large bank, and there is a risk that these safeguards may not work as intended. Therefore, FINMA should closely monitor the effectiveness of these safeguards to address potential conflict of interests within a banking group.

27. Significant valuation errors must be reported immediately to FINMA. To address a recommendation made by the 2014 FSAP, the limits for assessing the significance of valuation errors were reduced by about half in the SFAMA guidelines, which came into force in July 2016. Several onsite visits at most of the fund managers and custodian banks were made by FINMA with a focus on risk management and internal controls on valuation and errors.

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[7] Guidelines on the Valuation of the Assets of Collective Investment Schemes and the Handling of Valuation Errors in the case of Open-End Collective Investment Schemes.

[8] Level 2 and level 3 assets are valued without quoted prices in active markets. Therefore, there is a room for a subjective judgement to derive the values.

Managing Redemption Risks

28. FINMA approval is required on redemption terms, and FINMA requires adequate redemption terms based on the specific investment strategy and underlying investments. FINMA approves securities funds only with daily redemption; weekly or monthly redemption is possible for other funds for traditional or alternative investments. The analysis of adequate redemption terms with respect to the investment strategy is part of FINMA's approval process. Investors in real estate funds may request the redemption at the end of each financial year with twelve months' prior notice, although many real estate funds are tradable and thus investors can trade their investments through the secondary market.

29. Fund managers have several tools to address redemption shocks (Table 3): (i) gates; (ii) side pockets; (iii) anti-dilution levy; (iv) redemption fees; (v) redemption in-kind; (vi) suspension of redemptions; (vii) swing pricing; and (viii) short-term borrowings. In exceptional cases, FINMA may require asset managers to limit deferral of a redemption in the interest of all investors. If necessary, FINMA coordinates measures with relevant foreign supervisory authorities. However, FINMA does not have the power to impose on an individual asset manager or the entire industry to defer/suspend redemptions: the decision to defer/suspend redemptions needs to be made by each individual fund.

Table 3. Switzerland: Liquidity Risk Management Tools

A wide range of liquidity risk management tools are available to the Swiss asset management and fund industry.

	CH	Regulation/Guidance
Gates	yes	Redemption gates in Swiss CIS have been approved by FINMA following an "*e maiore minus*" approach based on Article 81 of Collective Investment Scheme Act (CISA), which provides the legal basis for deferment of the repayment of units. An explicit provision in the Collective Investment Schemes Ordinance (CISO) regarding redemption gates might be introduced in 2020.
Side pockets	yes	In its news publication on January 23, 2009 FINMA informed that side pockets with regards to Swiss Funds of Hedge Funds were admissible, subject to the prior approval of FINMA and gave guidance on the requirements.
Anti-dilution levy	yes	Article 38 paragraph 1 of CISO states that investors may be charged all-in incidental costs incurred by the issue, redemption or conversion of units for the purchase and sale of investments.
Redemption fees	yes	Article 80 of CISA and Article 38 of CISO set out the rules on redemption prices including fees or commissions.
Redemption-in-kind	yes	Pursuant to Article 78 paragraph 4 of CISA, FINMA may allow a derogation from the duty to make payments in and out of the fund in cash.
Suspensions of redemptions	yes	Article 81 of CISA in conjunction with Article 110 CISO set out the rules for deferment of the repayment of units.
Swing pricing	yes	Based on Article 83 paragraph 3 of CISA the Swiss Federal Banking Commission (SFBC) in 2007 permitted the application of Swing Pricing (SFBC Annual Report 2007, p. 53).
Short-term borrowings	yes	The provisions per fund type regarding borrowing are as follows: Securities funds: Article 55 paragraph 1 lit. c CISA and Article 77 paragraph 2 CISO; Real estate funds: Article 60 and 65 CISA in conjunction with Articles 89 and 96 CISO; Other funds for traditional investments: Article 100 paragraph 1 a of CISO; Other funds for alternative investments: Article 100 paragraph 2 a of CISO.
Mandatory liquidity buffers	no	n/a
Side letters	no	n/a
Other tools/measures	yes	In the approval process of Swiss CIS, FINMA may require on a case-by-case basis that other/additional liquidity management measures (such as adequate redemption frequency, notice period, limiting illiquid assets, holding sufficient liquid assets etc.) are implemented in the CIS. It hereby also takes into consideration the suitable fund type (liquidity of underlying assets), eligible investors and investment strategy.

Sources: FINMA.

30. **FINMA requires risk management, including of liquidity risk, both at the asset manager and individual fund levels.** FINMA ensures, during the approval process of Swiss CISs, that necessary liquidity management measures (such as adequate redemption frequency, notice period, limiting illiquid assets, holding sufficient liquid assets, borrowing, redemption in kind, redemption gates, deferred payment, side pockets) are in place. FINMA has also conducted several offsite inspections of asset managers focusing on liquidity risk management and is following up the industry practices closely. FINMA also conducted 12 onsite inspections in 2018 at asset managers, some of which included liquidity and other risk management in their scope. While such inspections are important to prevent idiosyncratic incidents, they may not capture sector-wide risks, such as

undue concentration in specific segments, sectors, or entities. As recommended earlier, industry wide stress testing would help the authorities to capture those risks quantitatively.

Use of Leverage

31. The use of leverage is limited depending on the type of fund. For securities funds and real estate funds, the overall exposure may not exceed 200 percent of the fund's total net assets, including the exposure associated with derivative financial instruments. Other funds for traditional investments and alternative investments have limits of 225 percent and 600 percent, respectively.

32. Provisions on loans or guarantees are generally prohibited, and securities lending is subject to limitations. Securities funds may pledge or transfer the ownership as collateral of up to 25 percent of the fund's net assets. Provisions of loans or guarantees are prohibited for securities funds. Other funds for traditional investments and alternative investments may pledge or cede as collateral no more than 60 percent and 100 percent, respectively, of fund net assets. Security financing activities must be included in the leverage calculation, if the collateral is reinvested and such reinvestment results in higher return over the risk-free interest rate. An ordinance specifies the minimum criteria of eligible collateral that funds can receive and the management of collateral (such as diversification of collateral). FINMA also requires that the collateral value amount to at least 100 percent of the market value of the loaned securities at all times.

33. In May 2017, FINMA conducted a deep-dive exercise on securities lending activities by the asset management and fund industry. At end-March 2017, the market value of securities lent amounted to just under CHF 25 billion, which is equivalent to 2.6 percent of the AuM. The exercise revealed some notable differences in the materiality of use of securities lending, collateral agreements, and risk management. FINMA followed up on these observations to improve firm's risk management.

Custody and Safe Keeping

34. From the perspective of existing safeguards for related party custody, fund management companies and custodian banks can be related parties. The fund management company and custodian must be separate entities but can be related parties. Certain safeguards aiming at avoiding conflicts of interest are in place, such as separation of directors, and the external auditors assess compliance with these requirements. Every amendment within the custodian bank's organization is subject to FINMA's prior authorization; any changes within the Fund Management Company's Board of Directors or Executive Committee is also subject to FINMA's authorization. With the partial revision of CISA in 2013, additional regulations have been implemented on the outsourcing of custody, requiring that financial instruments be transferred only to regulated custodians, etc.

Limited Qualified Investment Funds (L-QIFs)

35. L-QIFs should be subject to intensive monitoring as well as proper risk management requirements through the management company or asset managers. The government is

working on a proposal to amend the CISA, introducing a new fund category (L-QIFs) that will be available only to qualified investors.[9] L-QIFs would be exempted from FINMA authorization and prudential supervision and they could invest in diverse assets. L-QIFs would be managed by a Swiss fund management company licensed and supervised by FINMA, and be subject to the same statistical data reporting as any other Swiss funds.[10] The set-up of the L-QIF follows the Alternative Investment Fund Managers Directive and similar products such as the reserved alternative investment fund from Luxembourg. L-QIFs could bring higher risk to Swiss qualified investors, particularly institutional investors, and need careful monitoring. The authorities should ensure that L-QIFs are subject to appropriate statistical data reporting and proper risk management requirements, proportionate to their potentially higher risk-taking activities.

Supervision, Regulatory Actions and Sanctions

36. FINMA uses several tools to monitor and supervise asset managers and funds, and recently introduced an "offsite inspections" program. The tools include offsite monitoring, onsite inspection, supervisory audits, and since 2017 also "offsite inspections." An offsite inspection is a desk review focusing on a particular case or theme. There were 12 desk reviews in 2017, and 9 in 2018, covering a wide range of topics, such as outsourcing, pricing errors, securities lending, and collateral management. With on- and offsite inspections, FINMA aims to cover about 10 percent of supervised entities each year. Consequently, the number of supervisory measures taken by FINMA substantially increased from about 100 in 2016 to over 250 in 2018 (Table 4).

Table 4. Switzerland: Number of Supervisory Measures

The number of supervisory measures taken by FINMA on asset managers and funds have been substantially increased.

	2016*	2017	2018
Number of supervisory measures	**112**	**237**	**255**
Supervisory reviews and deep dives	*18*	*24*	*23*
Desk reviews		*12*	*9*
Supervisory meetings		*33*	*32*
Supervisory letters		*48*	*77*
Intervention in audit procedure		*24*	*30*
Supplementary audit		*4*	*3*
Recommendation with obligation	*31*	*54*	*40*
Restoration of compliance with the law	*4*	*7*	*3*
Intensive supervision	*2*	*1*	*3*
Escalation to Enforcement		*5*	*2*
Other measures (not categorized)	*57*	*25*	*33*

Source: FINMA *A consistent categorization of measures is available as from 2017.

[9] Qualified investors include not only institutional investors (such as insurance companies and pension funds) but also high-net-worth retail investors (CHF 500 thousand + training/education) who has opted out from retail treatments, and other retail investors who have a discretionary investment contract with a financial institution.

[10] Or a Swiss company with a broader license such as a bank or insurance company.

37. The number of onsite inspections of asset managers and funds has increased significantly in the last four years. The majority of the inspections focused on particular cases and themes, such as a specific elevated risk, based on offsite monitoring, and possible regulatory breaches. Examples of inspection focus include risk management, real estate funds, valuation, mortgage funds, outsourcing to foreign groups, custody control, and market conduct.

38. FINMA uses auditors and investigating agents to complement its own supervision and inspections. The auditors are mandated by FINMA to conduct supervisory audits of the asset managers and funds. The number of irregularities and recommendations identified by these auditors was constant at about 700 per year between 2015 and 2018. FINMA can also appoint an investigating agent to address major regulatory breaches. During 2015–18, FINMA conducted one major enforcement proceeding in connection with an asset manager, and appointed an investigating agent to establish the facts. FINMA concluded that the asset manager had severely violated its duty of loyalty and due diligence toward its clients, thereby also violating the requirement of proper business conduct.

39. FINMA has introduced an enhanced enforcement policy and taken targeted actions against individuals, with increasing frequency of publication of individual enforcement cases. FINMA adopted a revised enforcement policy in 2014 and started to publish a yearly report on its enforcement activities (enforcement report). Consistent with its revised enforcement policy, FINMA has intensified its enforcement actions, taking action against individuals responsible for serious violations. To make such enforcement effective, FINMA has also established a database to assess compliance with proper business conduct requirements. Increasingly, FINMA publicly discloses individual enforcement cases ("naming and shaming").

40. However, enforcement limitations remain due to a lack of power to impose administrative fines. FINMA does not have the power to impose pecuniary administrative fines. In an extreme case, FINMA can revoke the license of regulated entities. However, this would result in liquidation of the regulated entities and associated funds. Consequently, this is not recognized as a very useable enforcement tool. FINMA can also ban professionals from working in leading positions in the Swiss financial market. FINMA is moreover, authorized to disgorge profits made through a serious violation of the requirements and made use of this power. For criminal violations, either Legal Services of the FDF or the Attorney General's Office can impose criminal charges including fines. However, FINMA cannot impose administrative fines on supervised entities. This means that one of the strongest incentives for supervised entities to comply with the regulations is missing from the tool box. This tool will become more important in asset management supervision in the near future, as FINMA will to supervise indirectly (through the two mandated industry organizations) a large number of small independent asset managers from 2020.

41. FINMA should be equipped with more comprehensive enforcement powers, including the power to impose administrative fines. The recent initiatives to enhance enforcement, such as more individual focus and more disclosure, are welcome and improve the incentive structure for large institutions and very small entities, these may not be so effective for medium-size institutions. The government has not addressed the recommendation in the previous FSAP to empower FINMA

to impose administrative fines. Flexible and prompt administrative penalties are effective tools to enhance the incentives for medium-size institutions. In addition to administrative fines, and within the current legal constraints, FINMA should increase the resources of the enforcement division and enhance further enforcement actions, including through more comprehensive disclosure of individual enforcement cases.