

Switzerland: ESG challenges for funds

Oliver Widmer and Manu Ferro of Pestalozzi outline the Swiss approach to the ESG evolution, with funds well-advised to take the jurisdiction's law provisions seriously

The range of funds available to investors who prioritise ESG has increased in recent years. The driver for the growing range of ESG funds is not only regulation, but also investors' demand for more sustainable financial products. The most recent market study by Swiss Sustainable Finance showed a growth rate for sustainable investment funds of 48%, an increase of sustainable mandates by 29% and of sustainable assets of asset owners by 15%.

Sustainable funds accounted for more than half of the total Swiss fund market in 2020, thereby exceeding conventional investment funds for the first time. There is also a shift in the type of investor: most sustainable investors are still institutional investors by absolute numbers. However, the volumes of private investors increased by 72% in 2020 compared to the lower growth rate of 20% of sustainable investments by institutional investors.

In the last few years, impact investing had the highest growth rate of all sustainable investments. Another development can be observed in transparency and reliability, as third-party certified labels and opinions are increasingly used. This trend reflects investor demand for more transparency in the sustainable investment market.

Vice versa, regulators and prosecutors have become more aware of the risk of greenwashing, i.e. the PR method that aims to give a company an environmentally friendly and responsible image in the public eye without a sufficient basis for doing so. In connection with asset management for example, the US-bank BNY Mellon was fined for misstatements and omissions about its ESG considerations. The SEC found that numerous investments in BNY Mellon's funds did not have an ESG quality review score that they claimed to have in the relevant fund documentation. Similar allegations have been made against Deutsche Bank's subsidiary and fund company, DWS.

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Given all these factors, namely the increasing demand for ESG investment opportunities, the increasing demand for transparency in this area, legal developments in the EU as well as the imminent risk that greenwashing brings for investors, it comes as no surprise that the Swiss regulator is actively issuing ESG rules and recommendations. In addition, privately organised associations have issued self-regulatory rules and guidelines regarding sustainable asset management or investment.

This article provides an overview of the applicable legal basis and requirements in Switzerland and discusses the ESG challenges funds face in the Swiss market.

ESG considerations for funds in the Swiss legal framework

Overview and terminology

Unlike the EU with its ESG legislation, namely the Sustainable Financial Disclosure Regulation and more recently, the MiFID II sustainability preference assessment, Swiss law, for a long time, did not provide for ESG-linked provisions. With the amendment of the Swiss Code of Obligations, new due diligence obligations and reporting requirements relating to ESG matters have been introduced, applying for the first time for the 2023 financial year.

Swiss financial market law still does not possess ESG or sustainability-specific

provisions for financial products and services with a sustainability link. However, existing rules may provide a sufficient basis for ESG considerations. The Swiss supervisory authority and regulator, the Swiss Financial Market Supervisory Authority (FINMA), can give guidance and adopt practical rules in its circulars, clarifying legal provisions and ensuring proper application of existing provisions. Furthermore, given that the increasing demand in ESG funds is primarily market-driven, the industry also has an interest to develop some form of guidance. Therefore, various industry representatives have issued recommendations and best practices that may take the form of self-regulation and soft-law.

FINMA has been particularly active in preventing greenwashing. However, FINMA does not only protect investors and clients but also the Swiss financial market, as greenwashing entails reputational and legal risks for the entire market. Collective investment schemes take a central role among sustainability-related financial products. FINMA's activity regarding collective investment schemes focuses on:

- Sustainability-related information on the fund level;
- Appropriate organisation at the institutional level and in the management of collective assets; and
- The advisory process at the point of sale.

In this article, the terms ‘ESG’ and ‘sustainability’ or ‘sustainable’ are interchangeably used. Although there is no clear definition for either of these terms, ‘sustainable’ can be understood to mean the practice of financial market participants to take certain ESG considerations into account.

Reporting obligations for funds on non-financial matters

Asset managers and collective investment schemes in Switzerland are subject to non-financial reporting obligations under the Swiss Code of Obligations, meaning that they must prepare a report each year on environmental matters. Environmental matters mean, in particular, CO₂ goals, social issues, employee-related issues, respect for human rights and combating corruption. The law provides for the minimum requirement of such a report, including a description of the business model and policies adopted by the relevant collective investment scheme or asset manager.

Furthermore, a presentation of the measures taken to comply with ESG considerations and the process of assessing the effectiveness of such measures need to be included into the report. A description of the main risks related to ESG matters of the relevant collective investment scheme or asset manager is also expected. Climate-related disclosure obligations are further specified in the implementing ordinance.

The report must be approved and signed by the executive management or governing body of the collective investment scheme or asset manager, as well as by the governing body responsible for approving the annual accounts. The report must be published online. The law provides for the possibility to base the report on national, European or international regulations if such regulations are mentioned in the report. If the relevant asset manager or fund prepares an equivalent report under foreign law, the report on non-financial matters according to Swiss corporate law does not need to be prepared.

For funds, collective investment schemes and asset managers operating in Switzerland, the new rules mean that these institutions should check whether they need to comply with the non-financial reporting obligations. Non-compliance with the duty to provide a report on non-financial matters may be sanctioned with fines of up to CHF 100,000 under the Swiss Criminal Code.

Sustainability considerations on the fund level

The management or safekeeping of assets held in collective investment schemes or the representation of foreign collective investment schemes in Switzerland is subject to authorisation by FINMA. Also, the establishment of a Swiss collective investment scheme or offering of foreign collective investment schemes, in Switzerland, to non-qualified investors requires prior approval by FINMA. The fund documentation is understood to include the investment agreement, the investment regulations or company agreement and, if available, the prospectus.

The Swiss Collective Investment Schemes Act (CISA), the relevant ordinance to the CISA (CISO) and the Swiss Financial Institutions Act contain the requirements for authorisation and approval. CISO contains a list of minimal requirements that must be included in the investment agreements, such as the name of

the investment fund. For ESG-linked funds, it is important to note that according to CISA, the name of the collective investment scheme must not give rise to confusion or deception, in particular with regard to the investments.

If ESG-attributes such as 'green', 'sustainable' or 'ESG' are included in the name or the fund documentation, FINMA will specifically pay attention to the explanations of these advertised characteristics. Hence, the fund documentation has to include all information that is necessary for the ESG investment. FINMA acknowledges that due to missing terminology, taxonomy and the large number of different possible sustainability strategies, it might not be easy to provide for transparency. However, according to FINMA, such transparency is indispensable.

In practice, funds should pay attention to the following guidelines as these are, among others, considered greenwashing (or potentially prone to greenwashing) by FINMA:

- A collective investment scheme has a sustainability reference without pursuing a sustainable investment strategy;
- The collective investment scheme provides for a sustainability approach, for example, the 'best-in-class' approach, without implementing such an approach; and
- Terms such as 'impact' or 'zero carbon' are used in the fund documentation but are not verifiable or measurable.

Sustainability considerations on the management level

Managers of collective investment schemes must be authorised by FINMA. For such authorisation the law requires, among other things, that the manager establishes appropriate corporate management rules and is duly organised to fulfil its statutory duties.

Managers of collective investment schemes with a sustainability focus should pay close attention to whether the investment decision process integrates certain sustainability-related criteria. They should also consider whether, regarding such investment decisions, an independent risk control is foreseen. The organisation of the collective investment scheme should provide for a process to inform the management of any facts that may affect a sustainable investment. The information obtained should enable the management or other competent bodies to monitor the progress

towards any ESG-related objectives. Risks inherent in sustainability shall be explicitly covered by the risk management (in addition to the usual investment risks).

Furthermore, FINMA expects that at senior levels, the necessary expertise and knowledge is available in the particular area of sustainability in which the investments are made. Hence, managers of collective investment schemes should ensure that the individuals involved in the management and investment process have the required background for their role. In addition, if tools, data or ratings related to sustainability are used, the manager of collective investment schemes has to provide for a process to validate and review these on an ongoing basis. For this, international and regional developments should be observed and adopted, if necessary or useful.

If the fund promotes active ownership or stewardship, the organisation needs to present how such ownership will be achieved, for example by specifying how the voting rights will be exercised and handled.

Sustainability considerations at the point of sale

Financial services providers (this includes investment advice relating to transactions with units in collective investment schemes), are subject to the provisions of the Swiss Financial Services Act (FinSA). Greenwashing can also occur during the advisory process, particularly when financial products with a sustainability link are offered.

While FinSA does not provide for specific sustainability-linked provisions, the general duty of due diligence and loyalty may apply. Under such duties, the financial service provider must inform and advise the investor of risks that the investment may have. As climate risks may lead to financial risks, the disclosure and advice on climate risks must be included in the investment process.

However, there is no explicit obligation on financial services providers to include ESG-preferences in the suitability test if they provide portfolio management services or certain investment advisory services. Certain self-regulatory rules, for example the Swiss Banking Association's 2022 guidelines, state that the investor's ESG considerations should be included in the suitability assessment and that investors should be proactively informed of ESG-investment solutions.

In absence of such legal obligations, recommendations or guidelines have been issued by industry representatives. These should be observed by financial services providers at the point of sale, also considering that in other jurisdictions, the inclusion and observance of an investor's ESG-preferences may be required.

Concluding thoughts and outlook

Due to FINMA's focus on the prevention of greenwashing, market players are well advised to consider Swiss law provisions as well as recommendations and guidelines issued by privately organised associations. As FINMA's scope of action for efficient greenwashing prevention is bigger for financial market participants requiring an authorisation or being (prudentially) supervised by FINMA, it can be expected that FINMA pays even more attention in these fields. Therefore, funds and managers of collective investment schemes should establish and enhance adequate organisational structures and processes to comply with the authorisation requirements.

On the other hand, due to the lack of specific sustainability-related transparency obligations and effective supervisory foundations for action at the point of sale, financial services providers might be less in FINMA's focus. However, given the international developments in this field and the attention of the market, financial service providers should also consider establishing a process to cover ESG-preferences of the investor in their documentary obligations and suitability and appropriateness test.

Lastly, even though sustainability of investments might not be the number one concern for investors in the current state of the world, one can expect that the matter is not off the table and that ongoing legal projects in this field will be pursued. Hence, the number of legal projects and initiatives from the industry will likely also increase in Switzerland.



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