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CONCENTRATION RISK

Compliance | 06/2025

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Summary

FINMA Circular 2025/2 introduces guidance on conduct obligations under the Financial Services Act (FinSA), including the management of concentrations risks (hereinafter, the “**Circular**”). The Circular indicates as reference thresholds:

- ≥ **10%** on individual securities;
- ≥ **20%** with individual issuers

when these limits are exceeded, the portfolio manager is required to notify the client about the associated risks.

These thresholds are **indicative, not absolute**, and can vary depending on the type of instrument and portfolio strategy.

Special attention is required for certain structured financial instruments, such as **Actively Managed Certificates (AMCs)**, where risk segregation and diversification need a more tailored assessment.

Concentration risk

Concentration risk refers to the risk of significant losses when a large portion of a portfolio is invested in a limited number of financial instruments, issuers, sectors, or geographic regions. In other words, if a portfolio is not sufficiently diversified, even a single negative event - such as an issuer’s default, a sector downturn, or a regional crisis - can have a disproportionate impact on its overall value.

Concentration risk is managed in two main areas:

- **Per Asset Class**: concentration risk limits are defined per asset class in the asset allocation within the management agreement with the client.
- **Per Single Investment**: concentration risk limits are now determined by the **Circular**.

The FINMA Circular 25/2

The Circular qualifies the following thresholds as in line with established market practice:

- ≥ **10%** on individual securities;
- ≥ **20%** with individual issuers.

Consequences for the management of the concentration risk

The consequences of exceeding the concentration thresholds vary depending on the type of threshold that is exceeded:

- **Asset allocation:** when the agreed allocation limits are exceeded, the portfolio exposure must usually be reduced to remain within the boundaries of the mandate. Alternatively, the client may be consulted to decide whether to adjust the asset allocation to reflect a revised strategy - for instance, in cases where increasing the limit for a specific asset class could be justified by the client profile and the market.

- **Single investments:** when the reference thresholds for single positions are exceeded, the portfolio manager is required to notify the client about the associated risks.

For example, a client may agree in the asset allocation that the portfolio manager will invest 30% of the portfolio in bonds. If the manager then decides to allocate 13% to a single bond and 7%, 5%, and 5% to others, the FINMA limits for individual positions are exceeded even if the overall asset allocation limits have not been breached. In this case, the client must be promptly informed, as the regulatory thresholds have been reached.

In practice, when notifying a client about a threshold breach, it may be useful to review the overall asset allocation at the same time to ensure the portfolio remains aligned with the client's objectives and risk profile.

Indicative limits for concentration risk

These thresholds indicate in the Circular are **not binding legal limits** but indicators of unusually high concentration. According to the FINMA Commentary to Circular 25/2 (issued on 31 October 2024), these thresholds may be adjusted based on the quality of the instruments, the issuer's risk profile, and the complexity of the investment strategy.

The Asset Manager may draft a specific directive that sets individual percentage limits for certain financial instruments, which may differ from those in the Circular.

For example, the concentration limits for Investment-grade government bonds, which are considered low risk, could be set higher than those established in the FINMA Circular. Conversely, in cases where the instruments present higher risk, the thresholds could be set lower.

Treatment for Funds and AMC

For regulated investment funds and ETF, which already comply with diversification rules at the product level, the 10/20% thresholds do not apply, as these collective investment schemes are already subject to rules ensuring proper risk diversification.

However, no explicit exclusion exists for AMCs, leaving managers in a regulatory grey zone and requiring a deeper analysis. As asset managers increasingly use AMCs to manage large portions of their clients' portfolios, it is crucial to ensure that diversification principles are respected and that clients are adequately informed about any associated concentration risks.

In the AMCs market practice, issuers commonly structure their vehicles through multiple **segregated** cells, each representing a distinct certificate. These cells operate independently under a shared issuance platform yet maintain a robust legal and operational separation. It is standard for such issuers to ensure that:

- Each cell is autonomously ring-fenced in terms of assets and liabilities;
- The issuing entity is structured as an orphan special purpose vehicle, with no operational ties to other companies or obligations beyond maintaining its legal existence and servicing the certificates;
- The failure or liquidation of one cell does not affect the solvency or performance of the others.

This design effectively eliminates counterparty risk at the issuer level, making each cell an isolated economic unit.

According to this interpretation, the 10% product and 20% issuer thresholds should be calculated per cell, not per legal entity. Therefore, multiple cells of the same AMC vehicle may each invest beyond the thresholds, provided they do so independently and that the exposures are not aggregated for the same client.

This approach aligns with the Circular, promoting transparency and client protection without imposing unnecessary limits where no real concentration risk exists.

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