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Collaterals in Connection with the Act on Book-Entry Securities

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In the last issue (CapLaw-2009-55), Renato Costantini opened a planned series of articles on the new Act on Book-Entry Securities (Book-Entry Securities Act, BESA) by giving an overview of the principal points of the new legislation, which in its entirety will come into legal effect on 1 January 2010.

With this article, the series shall be continued by focusing on the issue of collaterals under the BESA and the related provisions.

By Niklaus Dietschi / Rémy Messer

1) Collaterals in Connection with Collective Custody, Global Certificates and Uncertificated Securities outside the BESA

The legal concepts of *collective custody, global certificates* and *uncertificated securities* will be given a statutory basis by the new articles 973a-c of the amended Swiss Code of Obligations (amended CO). In cases where securities are either entered into collective custody, represented in a global certificate or not physically issued at all, but no book-entry securities in the sense of the BESA are created, the *collateralization* of such securities is governed by provisions *outside the BESA:*

- Pursuant to article 973a (2) amended CO, the depositor who hands fungible securities into ***collective custody*** with a collective custodian becomes a co-owner (pursuant to articles 646 et seqq. Swiss Civil Code (CC)) in the collective pool of fungible securities of the same kind. In these cases the collateral may be created either by way of pledging the co-ownership right (article 901 CC) or by a simple transfer of the co-ownership right for collateralization purposes. In the latter case the transferee assumes full co-ownership right.

- The same collateralization procedure applies for an issued ***global certificate*** pursuant to article 973b amended CO: The security holder has a co-ownership right with respect to his part of the securities represented by the global certificate and may as well create a security interest by pledging his co-ownership right or by a transfer of the co-ownership right for security purposes.

- With respect to the granting of collaterals in ***uncertificated securities*** it has long been disputed among legal scholars whether such securities are established by way of a pledge of claims or by way of a pledge of *other rights* (article 899 CC). This controversy will be resolved: Article 973c amended CO clearly states that the pledge of these uncertificated securities must be made in accordance with article 900 CC (*i.e.* as a pledge of claims). Furthermore, as no physical security is issued, a trans-

fer for collateralization purposes is not possible. Hence, article 973 (4) amended CO states that uncertificated securities may be collateralized by way of assignment for security purposes in the sense of article 164 et seqq. CO.

2) The Creation of Collaterals under the BESA

a) Collaterals by Security Transfer (Article 24 BESA)

One way of creating collaterals is to transfer the book-entry security to the secured party's account, based on an order of the security provider. From a legal point of view the transfer can be considered as the consummation of the collateral creation, based on an obligation under a security agreement. In most cases, this underlying security agreement will provide for a fiduciary transfer of full title; however, in the context of article 24 BESA it would also be possible that the underlying agreement provides for a mere pledge.

The collateral creation by transfer of full title for security purposes is advantageous for the secured party, because the secured party's authority over the collateral exceeds the rights granted by the underlying security agreement. For instance, the secured party would legally be in a position to realize the collateral by selling it to a third party even though no event of default pursuant to the underlying financing-transaction has occurred. Finally, another advantage for the secured party lies in the exclusion of the retention and realization right of the intermediary as well as in the exclusion of potential liens the intermediary may have vis-à-vis the security provider (articles 21 (2) and 26 (2) BESA).

In the context of article 24 BESA, the shareholder's economic and membership rights related to the shares are entirely transferred to the secured party. As a consequence, collateral creation in book-entry securities of Swiss companies at least partially listed in Switzerland may trigger the obligation to notify the company and the stock exchange pursuant to article 20 Swiss Stock Exchange Act (SESTA).

b) Collaterals by Granting the Secured Party the Right to Give Instructions (Article 25 BESA)

Another way of creating collateral is for the security provider to irrevocably agree with the intermediary and the secured party that the intermediary shall henceforth – without further consent of the account holder (security provider) – follow the instructions of the secured party. In an event of default in the underlying transaction to be secured, the secured party has the right to realize the collateral without the cooperation of the account holder that has provided the collateral. Such pledge-like collateral creation without transfer of the book-entry securities does not require a specific legal form, but usually will be stipulated by way of a three-party agreement among the security provider, the secured party and the intermediary which acts as quasi pledgeholder.

Pursuant to article 25 BESA and contrary to the collateral creation by security transfer, the shareholder's economic rights (*e.g.* rights to dividends or preferred subscription rights) and membership rights (*e.g.* voting rights) remain with the security provider, as the book-entry securities remain in the security provider's account and are only earmarked as subject to a security right. Moreover, presumably no notification obligation pursuant to article 20 SESTA will arise, unless – for instance – the parties have agreed that the secured party shall exercise the voting right based on a power of attorney or if the secured party proceeds with the realization of the collateral.

Within the scope of article 25 BESA it may be detrimental for the secured party that the retention and realization right of the intermediary as well as potential pre-existing liens of the intermediary vis-à-vis the security provider (articles 21 and 26 BESA) will prevail as a consequence of the principle of priority, if not waived by the intermediary within the relevant security agreement. This principle of priority will also determine the rank between multiple collaterals according to article 25 BESA, unless otherwise stipulated by the parties.

The intermediary will act based solely on the instructions of the secured party and therefore will seek to explicitly exclude in the relevant security agreement any and all obligation to verify whether an event of default in the underlying transaction has occurred. Further, the intermediary will pay close attention to have only limited knowledge of the underlying transaction and will strive for liability exclusion to the extent possible; however, such liability exclusion will be restricted by article 100 (2) CO, according to which liability exclusion may be declared void by a court even in case of slight negligence, as intermediaries permitted by the BESA to act as intermediaries conduct a business carried out under an official licence.

The extent of the collateral in book-entry securities depends on the mutual agreement between the parties. The BESA explicitly allows to create a collateral (i) either in specific book-entry securities, (ii) in all book-entry securities being credited to the account the security provider holds with the intermediary, or (iii) in a quota determined as minimum value threshold of the book-entry securities being credited to the security provider's account. In the latter case – which, in essence, represents a statutory basis of the lombard loan – it needs to be ensured that, at any time, the value of the securities exceeds the total value threshold agreed with the secured party, whereas the security provider may freely dispose of the book-entry securities in excess of such threshold. Under Swiss law, this floating charge represents a unique suppression of the principle of speciality, *i.e.* the obligation to create security over certain clearly specified assets. It may also be admissible to create such floating charges in favor of the intermediary.

c) Collateral of the Intermediary (Article 26 BESA)

Pursuant to article 26 BESA, collateral in book-entry securities may be created in favor of the intermediary, with full effect vis-à-vis third parties. The creation of such collateral does not necessitate the segregation of the book-entry securities, nor is it necessary for the intermediary to specifically earmark the book-entry securities. Conflicts may arise when the same book-entry securities are subsequently used as collateral pursuant to article 25 BESA in favor of a third party, hence the intermediary is obliged to inform the third party of its pre-existing security interest; otherwise, the intermediary's collateral would rank behind the third party's collateral.

In any case, the collateral of the intermediary ceases to exist in the event of the transfer of the book-entry security to a securities account of a third party according to article 24 BESA.

d) Realization of the Collateral (Articles 31 and 32 BESA)

The BESA explicitly allows the secured party to effect the realization of the collateral in book-entry securities traded on a representative market by way of private realization and an acquisition on its own account, meaning that the secured party may either sell the securities and apply the proceeds to the secured obligations or acquire ownership of the collateral and apply the value of the collateral against the secured obligations. This right of the secured party is upheld during an insolvency procedure and remains unaffected by restructuring or protective measures of whatever nature. The security provider will have to be notified in advance of any intended realization of the collateral unless the security provider is a qualified investor and has waived such right. The secured party shall account for the realization and remit any excess proceeds to the security provider.

e) Release of the Collateral

Although not explicitly mentioned by the BESA, the release of the collateral in the sense of article 24 BESA will be effected by the issuance of a corresponding order by the secured party and a subsequent retransfer to the securities' account of the security provider. The collateral in the sense of article 25 or 26 BESA will be released by a release declaration of the secured party.

3) An Eye on Security Agreements over Book-Entry Securities

The following shall constitute a list of selected aspects to be considered and reflected within security agreements over book-entry securities *(cf. also the list proposed by Harald Bärtschi, AJP 9/2009, p. 1083):*

- Determination of the ***parties*** (agreements pursuant to article 25 BESA may be structured as three party agreements between the security provider, the secured

party and the intermediary, although it is argued that the rights and duties of the intermediary should be governed by a separate agreement in order to avoid an implicit obligation of the intermediary to verify whether an event of default has occurred pursuant to the underlying transaction);

- Specification of the ***secured obligations;***
- Specification of the ***type*** of collateral (article 24, 25 or collateral of the intermediary pursuant to article 26 BESA);
- ***Duration*** and ***release*** of the collateral;
- Provisions for the event of ***delivery of the underlying security instrument, global certificate or uncertificated security,*** as the collateral pursuant to article 25 or 26 will be extinguished with such delivery (*e.g.* substitute collateral in the underlying certificate or uncertificated security);
- ***Specification*** of the book-entry securities to be used as collateral (certain or all book-entry securities, floating charge) and ***extent*** of the collateral (*e.g.* as regards dividend payments and other interests);
- ***Right of disposal*** of the collateral and exercise of ***share voting rights;***
- ***Rank*** of the collateral if several collaterals pursuant to article 25 BESA are created (*i.e.* modification of the principle of priority);
- As the BESA does not clearly stipulate the ***priority of the intermediary's retention right*** (article 21 BESA) over a third party collateral pursuant to article 25 BESA, such priority may for the sake of clarity have to be explicitly acknowledged by the secured party or – as the case may be – waived by the intermediary in the context of a security agreement pursuant to article 25 BESA;
- Reference to or coordination with ***pre-existing liens*** of the intermediary (article 26 BESA, cf. article 30 (2) and (4) BESA);
- Agreement on a right of ***collateral increase*** or ***replacement*** pursuant to the amended article 287 (3) Debt Enforcement and Bankruptcy Act;
- ***Liability exclusion*** to the extent possible and an exclusion of the obligation of the intermediary to verify whether an event of default has occurred pursuant to the underlying transaction;

– Special provisions or constraints regarding the ***realization*** of the collateral (private realization, self-sale, waiver of notification requirements in case the security provider is a qualified investor, etc.);

– Applicable law and jurisdiction, in line with the Hague Securities Convention, the Federal Act on Private International Law, and the Lugano Convention.

4) Outlook

Book-entry securities will automatically come into effect as of 1 January 2010, as far as the requirements set out in the BESA are met. Hence, security agreements should already reflect the new rules introduced by the BESA. In particular, as the creation of collaterals over book-entry securities is exclusively governed by the BESA, it will be advisable to adequately reflect the parties' understanding of the collateral in the relevant security agreements, otherwise the enforcement of the collateral governed by it might be compromised.

Lastly, there may be a need to regularize past disposals (*e.g.* granting of a pledge): The disposal of collectively deposited securities, global certificates and uncertificated securities that occurred before the enactment of the BESA and which is not compliant with new transfer requirements will only prevail over disposals made after the BESA takes effect, if such conflict is remedied by the transferee by the end of 2010.

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Newsflash Securities Trading

Reference: CapLaw-2009-73

By Andrea Huber

Areas of Focus for the Review of 2009 Annual Financial Statements: In its review of the 2009 annual financial statements, SIX Exchange Regulation intends to focus in particular on compliance with the IFRS provisions regarding (i) measurement and disclosure of financial instruments (IAS 39/IFRS 7), and (ii) reporting on operating segments (IAS 36/IFRS 8). This list also applies to the issuers that apply US-GAAP. Further, as of 30 September 2009, the IFRS Circular No. 2 has been revised and amended. IFRS Circular No. 2 substantiates the obligations of issuers who have chosen to apply IFRS accounting standards and makes reference to IFRS rules that, in a number of instances, have given rise to complaints from SIX Exchange Regulation (for further details see http://www.six-exchange-regulation.com/admission_manual/09_05-SER200905_en.pdf).

Areas of Focus for the Review of 2009 Annual Reports with regard to Compliance with the Directive on Information relating to Corporate Governance (DCG): With respect to the corporate governance section of the 2009 annual reports, SIX Exchange Regulation will in particular pay attention to the (i) content and method of determining compensation and shareholding programmes (point 5.1 Annex DCG), (ii) additional fees paid to external auditors (point 8.3 Annex DCG), and (iii) information instruments pertaining to an external audit (point 8.4 Annex DCG). By rigorously enforcing the provisions of the DCG, SIX Exchange Regulation aims to improve the transparency of periodic reporting, in particular relating to corporate governance (for further details see http://www.six-exchange-regulation.com/admission_manual/09_04-SER200904_en.pdf).

Listing of Collateral-Secured Instruments: SIX Swiss Exchange AG (SIX), in collaboration with SIX SIS AG (SIS), offers issuers a service to collateralize certificates. A collateral provider will secure such instrument in favour of SIX. The collateralization is based on the "Framework Agreement for Collateral Secured Instruments", which the issuer and the collateral provider conclude with SIX and SIS. If certain events defined in the Framework Agreement occur, the collateral will be liquidated (for further details see http://www.six-swiss-exchange.com/download/admission/cosi/ibt_fs_aug09_en.pdf).

Trading in Defaulted Bonds after Maturity: Under the Rules for Trading in Delisted Bonds on SIX Swiss Exchange of 29 October 2008, delisted bonds from issuers in liquidation or similar proceedings may be traded on SIX. These rules apply *mutatis mutandis* to trading in defaulted bonds which have not been repaid upon maturity. Any SIX participant may apply for trading in defaulted bonds. Different from than delisted bonds, defaulted bonds are only admitted for trading for a limited period of twelve months after their maturity; this period can be extended (for further details see http://www.six-exchange-regulation.com/admission_manual/08_02_04-COM200904_en.pdf).

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Foreign Securities and the Act on Book-Entry Securities

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On 1 January 2010, the Swiss custody system will undergo a major reform with the entry in force of the Act on Book-Entry Securities (Book-Entry Securities Act, BESA). The BESA, taken at face value, focuses on the Swiss custody system and on securities issued by Swiss issuers. Yet, the bulk of securities held by Swiss financial intermediaries are issued by foreign entities and indirectly held through complex custody chains involving foreign sub-custodians and ultimately a foreign central security depository. In some instances, the chain will be based on a model of direct-ownership of

the security by the investor; in others, it will be a chain of beneficial ownership. Occasionally, both systems will apply at different levels of custody.

The great leap forward prompted by the enactment of the BESA could therefore not leave foreign securities held with Swiss intermediaries untouched. The Swiss law-makers, however, did not tailor a bespoke solution for foreign securities nor did they exclude them from the scope of their reform. Instead, they relied on two instruments: on the one hand, they anticipated the entry in force of the Hague Securities Convention by autonomously using the international treaty as Swiss internal rules on conflicts of laws (see article 108c of the Federal Act on Private International Law (PILA)). On the other, they apply the BESA to securities held with an intermediary without making a distinction as to the place of incorporation of the issuer, thus theoretically treating foreign securities the same way as Swiss securities. Against this backdrop, this article reviews the legal regime governing foreign securities held with Swiss intermediaries. First, it examines the scope of the Hague Securities Convention and the rules of conflicts it provides and then it moves on to examine how Swiss substantive law deals with foreign securities.

By Rashid Bahar

1) The Hague Securities Convention

a) Scope

Pursuant to article 108c PILA, the rules on conflicts of law of the Hague Securities Convention determine the law applicable to securities held with an intermediary. Thus, Swiss courts will apply the Hague Securities Convention as Swiss private international law before it formally enters into force as an international treaty. Therefore it is necessary to define closer what is a "security held with an intermediary" and what legal issues the Hague Securities Convention addresses.

i. Securities Held with an Intermediary

The entry point to the Hague Securities Convention is the notion of *securities held with an intermediary* (see article 2 (1) of the Hague Securities Convention), which calls in turn to defining the term *security* and the phrase *held with an intermediary*. When contemplating the Hague Securities Convention, it is of essence to bear in mind that virtually any financial instrument or financial asset, other than cash, is deemed a security and, to the extent it is held with an intermediary, falls within the scope of the Hague Securities Convention (article 1 (1)(a) of the Hague Securities Convention).

Similarly, the notion *held with an intermediary* under article 1 (1)(f) of the Hague Securities Convention is broadly defined as to apply to all modes of custody, ranging from English law beneficial ownerships of assets held in custody, to U.S. U.C.C. article 8 securities entitlements and all the way to continental European mediated *possession* schemes based on contract and not property law. Thus, the rule of thumb is when in

doubt, apply the Hague Securities Convention. A few rare exceptions subsist with uncertificated deposits of precious metals and securities that are not held with an intermediary, but are directly held with and booked with an issuer or a transfer agent acting on its behalf, without any intermediation of title or possession of a central securities depository or even a depository.

This all-encompassing approach leads a wide range of investments to potentially fall under the scope of the convention: in addition to common stock, bonds, and notes, over-the-counter (OTC) derivatives, limited partnership interests in private equity vehicles or shares of offshore hedge funds can all qualify as securities under the Hague Securities Convention and, if held with an intermediary, fall within the scope of the convention.

ii. Property Law Aspects of Securities Held with an Intermediary

In a somewhat simplifying manner, the Hague Securities Convention can be summarized as determining which law governs the proprietary aspects of holding a security through an intermediary. While the term proprietary is a misnomer as securities need not be personal property or even interests in personal property, the reference to property law captures the gist of the scope of the Hague Securities Convention: it determines which law defines the legal nature and effect against intermediaries and third parties resulting from a credit of a security to a securities account (article 2 (1)(a) of the Hague Securities Convention), the legal nature and effect against intermediaries and third parties of a disposition of a security (article 2 (1)(b) of the Hague Securities Convention), as well as other rules of property law such as perfection of security interests, priority, realization and scope of entitlement (article 2 (1)(c) to (g) of the Hague Securities Convention). These issues are typical property law issues. However, the rules apply to all types of intermediation structures, both direct ownership models and split-ownership custody systems. In other words, the Hague Securities Convention applies also when the rights of the investor against the intermediary are pure contractual claims, with no proprietary effect, and is by no means limited to Anglo-American custody schemes.

By contrast, the Hague Securities Convention does not aspire to determine the law applicable to the rights arising out of the securities (article 2 (3)(c) of the Hague Securities Convention) or the relationship with the issuer or a transfer agent in any other way. In other words, and by blatantly over-simplifying, the Hague Securities Convention deals with the right to the security and the conveyance of securities, but not with the rights resulting from the security, leaving out of its scope the questions related to the rights a security conveys, *e.g.* the content of rights against the issuer. Practically speaking the Hague Securities Convention determines the law which governs the question whether or not a given person acquired a security, but it does not determine what rights that person acquired under the security. In the context of shares, this issue will be de-

termined by the law of the place of incorporation of the issuer (article 156 (1) PILA) and, in connection with bonds and other debt instruments, by the law governing the terms of the instrument (article 116 ff. PILA).

However, this distinction between rights to the security and rights of the security has its limitations: corporate restrictions to share transfer are often borderline cases. On the one hand, they prevent the transfer from operating and thus could be viewed as an issue governed by the Hague Securities Convention. On the other hand, they actually seek to prevent a given person to exercise the rights of a shareholder and thus are more akin to rights arising out of the share. Considering the intimate connection between membership in a company and corporate law, the latter view should probably prevail. However, there is no conclusive answer to this controversy and, as we shall see, this issue is by far not immaterial as the Swiss BESA provides for overriding language barring any transfer other than the ones known to Swiss law from operating (see article 24 (4) BESA).

On another level, the Hague Securities Convention also does not determine the law applicable to the contractual relationship underlying a disposition of securities interest (article 2 (3)(b) of the Hague Securities Convention). Thus, sales of securities or agreements to charge a security will continue to be governed by the law applicable to the contract, whereas the actual transfer or creation and perfection of the security right will be governed by the law determined by the Hague Securities Convention. Similarly, the contractual relationship between the intermediary and the account holder continues to be governed by the ordinary rules on conflicts of law (article 2 (3)(a) of the Hague Securities Convention) and the liability of an intermediary under the custody agreement will be determined by the law applicable to the contract without reference to the Hague Securities Convention. As mentioned above, however, the effect of the contract in terms of the rights of the investor against the intermediary and third parties, is part of the proprietary aspects covered by the Hague Securities Convention and within the scope of the rules on conflicts of laws of the Hague Securities Convention.

Finally, the Hague Securities Convention does not seek to override applicable insolvency law. Thus, while property rights created before the commencement of insolvency are governed by the law determined by the Hague Securities Convention (article 8 (1) of the Hague Securities Convention), the relevant insolvency law—usually the *lex fori*—governs any disposition made after the commencement of insolvency and any claw-back or fraudulent conveyance claims against transactions entered into prior to insolvency (article 8 (2)(a) of the Hague Securities Convention).

In sum, the Hague Securities Convention determines the law applicable to *proprietary* relations in connection with securities held with intermediaries. However, the term proprietary is used in a functional manner and does not limit itself to questions governed

in a given jurisdiction by property law and may encompass certain contractual issues. By contrast, the Hague Securities Convention does not seek to address the contents of the security or of the contractual relationships leading to transfers or custody of securities, nor does it seek to override any insolvency law related issues, which would usually be governed by the *lex fori*.

b) PRIMA Approach

Moving to the content of the conflict rules, the Hague Securities Convention relies on the *PRIMA* approach (place of relevant intermediary approach) to determine the law applicable to securities held with an intermediary. As *property law* rules, the Hague Securities Convention imposes a reality test (article 4 (1)(a) and (b) of the Hague Securities Convention), which limits substantially the discretion of the parties. While the parties are free to choose the law applicable to securities held with an intermediary, in most cases their choice will be reminiscent of elections in single party states: the parties may only choose the law of the place of the office of the relevant intermediary. The relevancy of an intermediary is determined by verifying that the office of the intermediary maintains the security accounts (*e.g.* by effecting or monitoring entries to an account or by administering payments related to a securities account) and is identified by an account number, a bank code or otherwise as maintaining the account in such jurisdiction.

In most cases, the PRIMA approach will be sufficient to determine the applicable law even absent a choice of law as the same test of the place of the relevant intermediary will determine the applicable law wanting an express choice of law clause. Indeed, the Hague Securities Convention provides for fall-back rules and applies the law of the place of the relevant office of the intermediary, if such office is unambiguously identified in the account agreement (article 5 (1) of the Hague Securities Convention). Wanting any clear identification, the Hague Securities Convention retreats to the law of the place of the principal registered office (and as an ultimate recourse to the law of the place of the principal office) (article 5 (2) and (3) of the Hague Securities Convention).

In other words, the PRIMA approach focuses on where the account of the investor is administered and disregards other potential conflict rules such as the law of the place where the certificate documenting the security is physically stored *(lex chartae sitae)* or the law of the place where the issuer of the security is incorporated. The advantage of this regime is twofold: first, it subjects all securities held with an intermediary to the same laws, thus avoiding the need for an in-depth analysis of the laws of the issuer of the security or of the various parts of the custody chain. Second, as long as the Hague Securities Convention applies, the entire proprietary relationship at a given level of custody is subject to a single legal system, including when the account holder and the intermediary agreed to a choice of law.

While simple, this rule has far reaching consequences, it leads a choice of law agreed to by the account-holder and the intermediary to be opposable to any third party, thus marking a significant departure from the principle of privity of contracts. The only protection third parties can rely on in this context applies in the event the parties chose to change the applicable law after the creation of a vested right in a security account. In all other circumstances, any third party intending to acquire a proprietary right bears the *onus* of inquiring from the intermediary or the account-holder what law applies to securities held with the intermediary. Thus, general unsecured creditors do not benefit from any protection against a change of law which would operate to their detriment.

c) Conclusion

While entailing a significant simplification for depositories and investors alike, the benefit of these rules should not be overestimated. Indeed, taking a global view, the advantages of the Hague Securities Convention are constrained by rules on conflicts of law of other jurisdictions. If, for any reason, a matter is brought in front of another jurisdiction, other principles on conflicts of law (which *e.g.* apply the law of the place of incorporation of the issuer or the law of the place where the securities are physically deposited) will apply and potentially recognize a competing claim.

In sum, while the unilateral application of the principles on conflicts of law enshrined by the Hague Securities Convention will significantly simplify the determination of the law applicable to securities held with financial intermediary for financial institutions and investors it does not eliminate all uncertainties relating to the law applicable in global custody relations in particular in the event of competing forums.

2) Book-Entry Securities Act and Foreign Securities

Moving into domestic Swiss law, foreign securities raise three types of issues: first, which foreign financial assets fall within the scope of the BESA. Second, assuming the BESA applies, what rights does an investor holding foreign securities with a Swiss intermediary actually have under Swiss law? This question may seem at first glance obvious. However, due to the complexity of international custody chains, there is more than meets the eye at first glance. Finally, a related issue is to what extent is a Swiss custodian liable for a sub-custodian.

a) What is a Foreign Intermediated Security?

The first step when approaching the BESA is to determine whether a foreign security held with a Swiss intermediary (*e.g.* a bank or a securities dealer) is an intermediated security under the BESA. Indeed, the BESA does not use the same definition of intermediated securities as the Hague Securities Convention. Thus, notwithstanding the entry in force of the BESA, common rules on the conveyance of personal property or

rights and claims will continue to apply to certain foreign *securities held with an intermediary* under the Hague Securities Convention.

At the outset, the BESA does not define when it applies to foreign securities and when not. Moreover, a quick glance through the BESA should be enough to see that the BESA was not drafted with securities of foreign issuers in mind, but rather focused on domestic securities. In particular, it would seem relatively difficult to try to fit a foreign entitlement in a security into one of the three categories of underlying entitlements of the *book-entry securities* (cf. article 2 (1) of BESA), in particular when dealing with true non-certificated book-entry securities. Therefore, the leading approach consists in taking a functional approach and applying the BESA to all foreign financial instruments and financial assets that look and feel like a Swiss intermediated security (cf. article 3 (1) of BESA and article 4 (2) of the preliminary draft of BESA).

This functional approach simplifies the analysis insofar as it allows the account holder and the financial intermediary to assume that when an investment looks and feels like a domestic intermediated security it is an intermediated security governed by the BESA avoiding any further need to inquire into the particulars of the investment or its mode of custody.

At the same time, as with any functional approach, this solution does not offer a clear-cut delimitation of the scope of the BESA. While listed shares, bonds and notes are undoubtedly within the scope, the issue is more difficult when handling other foreign financial assets: most probably positions in OTC derivative contracts, limited partnership interests do not qualify as an intermediated security under the BESA, although they are securities under the Hague Convention and consequently Swiss law applies to the property over these financial assets when they are held with a Swiss intermediary. And even with those assets, one could take the view that, when they are held with a Swiss financial institution acting as a nominee or a fiduciary agent who can transfer them from one of its client to another by book entries, they turn into intermediated securities under the BESA, thus creating an additional level of uncertainty.

The functional approach is particularly difficult to analyze when considering non-certificated shares in unlisted companies: on the one hand, shares are usually transferable membership interests, on the other such shares are subject to transfer restrictions, which make them practically non-transferrable without the consent of the issuer and the intervention of a transfer agent. In such instances, the functional approach cuts both ways: on the one hand, the shares cannot be effectively transferred by book entry and thus are probably not intermediated securities. On the other, one of the purposes of the BESA was to simplify and harmonize the modes of transfer of intermediated securities, thus, pushing to treat such shares as intermediated securities, potentially subject to any transfer restriction. In such cases, an extremely close analysis is called for to

determine to what extent the foreign shares are truly fungible and more importantly to what extent the credit of the shares to a security account really transfers title and even then a certain degree of uncertainty will subsist.

Therefore, while the functional approach offers a quick and clean answer with the most common types of financial assets such as listed shares and bonds, it does create a certain degree of uncertainty when handling slightly more exotic assets, such as limited partnership assets, OTC derivatives or even shares in closed-end corporate investment vehicles.

b) What Rights Does an Investor Have in Intermediated Securities?

To the extent Swiss law applies and the securities are within the scope of the BESA, the BESA applies as a matter of principle fully and indiscriminately to foreign securities. The rules on the transfers and disposition of the BESA do not distinguish between Swiss and foreign securities held with an intermediary. Thus, as a matter of principle, the rules on the constitution and perfection of security interests in intermediated securities apply fully to securities issued by foreign entities. Similarly, under the BESA, the investor has a direct entitlement in the intermediated security allowing it to exercise directly its rights against the issuer (article 13 (1) BESA); the intermediary only mediates the exercise of these rights either by representing the investor, *e.g.* when collecting payments, or by issuing a certificate allowing the investor to attend a general meeting or otherwise vote the shares (article 13 (2) BESA). However, in most instances, this principle will be limited by the fact that the law of the issuer determines the substance of the rights that an investor acquires by holding a security, or as we shall see by virtue of article 10 (2) BESA.

This approach would operate effectively if the Swiss intermediary were the only intermediary. However, it encounters certain problems once the whole picture of the custody chain is considered. Indeed, together with the functional definition of an intermediated security, this approach presents the risk that in a cross-border custody scheme the Swiss BESA would confer more rights to the customer than what the Swiss intermediary holds against the foreign sub-custodian. For instance, such an approach would be bound to clash with intermediated securities held in the United Kingdom, where the investor has only a beneficial interest in the securities, or the United States, where the investor has a mere security entitlement, in both cases subject to the central securities depository actual legal title to the security.

This risk is avoided by article 10 (2) BESA. Under this provision, when a Swiss intermediary holds securities through a foreign sub-custodian, which is not subject to the BESA, the investor acquires only so many rights as the Swiss intermediary has against the sub-custodian. This principle, which intuitively matches the property law principle of *nemo plus juris* amounts to conferring to a Swiss investor the same rights as the inter-

mediary acquired from the sub-custodian, *i.e.* a security entitlement under an American state law U.C.C. article 8 security entitlement when dealing with a US sub-custodian, a beneficial ownership in assets when dealing with an English sub-custodian, merely a contractual claim to the delivery of the securities or, at the other extreme, a full proprietary interest, when dealing with a direct ownership scheme.

A logical consequence of this provision is that, while it ensures a consistent solution along the custody chain, it limits the scope of the PRIMA approach and the unlimited application of the BESA. For instance, as a consequence of article 10 (2) BESA, cases where a *bona fide* purchaser would be protected against a faulty transfer under Swiss law may be decided the other way, because of the law applicable to the sub-custody relationship. Moreover, the investor will or will not be able to vote directly foreign securities and be considered as an owner of record, depending on the law governing the sub-custodian and eventually the foreign central security depository. Similarly, such foreign laws may directly affect the transferability of intermediated securities: a transfer restriction recognized at an upper level of the custody chain would prevent the overriding language of article 24 (4) BESA), which provides that certain transfer restrictions do not impede the transfer of intermediated securities. A foreign law may also lead to interests created at the upper level of the custody chain to potentially rank in priority over a security created in accordance with the BESA notwithstanding the language of article 30 BESA. Ultimately, such foreign law may also limit the rights of an investor to recover its securities held with a sub-custodian in the event of the insolvency of its depository or of the sub-custodian (see also article 8 (2) of the Hague Securities Convention).

In sum, although as a matter of principle, the BESA takes the PRIMA approach seriously and applies the same rules to all securities held with a given intermediary regardless of the nationality of the issuer or the place where a sub-custodian is located, it remains pragmatic enough to recognize that Swiss law cannot do much, if the upper tiers do not and apply other principles.

c) Sub-Custody and Liability of the Custodian

Beyond the issue of foreign securities, the BESA also contributes to clarifying the obligation of the intermediary when entrusting assets to a sub-custodian. This issue is necessary, as most foreign securities are rarely deposited directly with a Swiss institution, but are more often than not held through a foreign sub-custodian, who will in turn hold them through a central depository. In other words, sub-custody has become an unavoidable central element of investing in foreign securities. While an extensive treatment of this issue is beyond the scope of this article, a few important issues must be noted: first, the BESA takes a pragmatic view and authorizes as a matter of principle the delegation of custody to sub-custodians (article 9 (1) BESA). Moreover, it specifies that, as a matter of principle, such delegation does not require the consent of clients.

It is only where, the sub-custodian is not subject to regulation that the statute kicks-in and requires the authorization of the client (article 9 (2) BESA).

In addition to the actual possibility of delegating the custody, the BESA clarifies the scope of liability of the custodian in the event of a delegation to a sub-custodian: the custodian does not bear the full responsibility of the custody of assets held with sub-custodians. It is deemed to have duly discharged its duties to the extent it chose, instructed with care the sub-custodian and monitored on an ongoing basis that the sub-custodian still fulfills the conditions of the initial delegation (article 33 (2) BESA).

By contrast, the depository is not obliged to monitor how the sub-custodian actually discharges its duties nor ensure that it takes all measures necessary to protect the rights of the investors. If the sub-custodian was chosen by the investor without interference of the custodian, the latter can even go a step further and exclude any liability for the actions of the sub-custodian (article 33 (3) BESA). However, in the event the sub-custody arrangement profits mainly to the custodian, either because it outsourced all the custody to a third party or if it undertakes this function within the same group of companies, the custodian cannot rely on these exemptions and bears full liability for the actions of the sub-custodian (article 33 (4) BESA).

Overall, this regime cuts a balance between the reality of global custody and the principles of contract law. However, the added burden for delegation to a group company, while in line with general principles of contract law (see the decision 112 II 347 of the Federal Supreme Court), takes a bias against global banking groups, who bear a greater exposure than local institutions, in circumstances where sub-custody is unavoidable. Thus, it indirectly creates incentives to rely on third parties, beyond the reach and control of the local Swiss bank, to assume sub-custody of foreign securities.

d) Conclusion

Looking at the broader scheme of things, the Hague Securities Convention and the BESA seek to simplify and provide legal certainty to the custody of securities held with an intermediary. To a large extent, they meet this objective by applying a single set of *property* law rules to a given portfolio of financial investments and avoiding a detailed analysis of any single security or interest in a security, of the custody chain and laws of foreign jurisdiction. However, the reform brought about by the Hague Securities Convention and the BESA falls short of fully achieving this goal at several levels: as long as other jurisdictions do not adopt the PRIMA principle, the possibility of a contradictory decision in a foreign court cannot be excluded. Similarly, by limiting the rights of the investor to the ones the intermediary holds against the sub-custodian, the BESA lets the custody chain influence the entitlement of the ultimate investor. While this rule is sensible and pragmatic, it undermines the PRIMA approach and forces diligent investors and custodians to determine what is exactly mediated through a foreign intermediated

security. Nevertheless, once the first uncertainties of this new legislation will be conclusively resolved, Switzerland, as a financial center specialized in serving end-investors, will overall profit from the simplifications that the Hague Securities Convention and the BESA promise.

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What's on FINMA's Agenda? – A Brief Survey of Regulatory Initiatives and Projects in Switzerland

Reference: CapLaw-2009-75

The financial crisis has resulted in a flurry of regulatory activity worldwide. Despite repeated calls for regulatory restraint, the G-20 summit appears to have paved the way for significant regulatory action. Furthermore, on 7 September 2009, the Basel Committee announced measures to strengthen the regulation of the banking sector. Likewise, the *too-big-to-fail*-phenomenon is on the agenda of the Financial Stability Board. This article looks at the position of the Swiss Financial Market Supervisory Authority FINMA in the context of such regulatory trends.

By René Bösch

The almost unprecedented nature, depth and geographical reach of the market turmoil resulting from the subprime crisis raised major challenges for all participants in the financial industry and in particular for the regulators and supervisors. More concretely, the almost daily reporting of bad news from financial institutions in the US and in Europe during many months challenged these regulators and supervisors to re-evaluate their approach to the supervision and regulation of banks, in particular investment banks. While some politicians, as well as a non-negligible part of the public at large, were quick to call for more and intensified regulation and supervision of investment banks, more considerate voices have called for a thorough and in-depth analysis of the subprime crisis before jumping to conclusions.

Some 18 months ago, I joined those voices that called for regulators' restraint in adopting new regulations. The Swiss regulator did initially follow that path, but things started to change in the fall 2008.

1) Early Responses of the Swiss Banking Regulator to the Financial Crisis

In the early stages of the financial crisis, many observers initially attributed the emerging problems to the hedge fund industry and their exposure to the financial industry at large. However, probably surprising to some, little by little it became clear that the reg-

ulated financial intermediaries, in particular investment banks, rather than the hedge funds played the crucial role in the credit crisis in the United States. In line with many other country's regulators, the Swiss Federal Banking Commission (SFBC) (predecessor of the Swiss Financial Market Supervisory Authority FINMA (FINMA) for the supervision of banks) concluded in its September 2007 report that from a regulatory perspective it would be most efficient to address any systemic risks originating from the hedge fund industry by way of regulating not the hedge funds themselves, but rather the counter-parties to the hedge funds, namely the banks, probably in a manner more comprehensively and intensively than has been done to date. Similarly, the March 2008 report of the Senior Supervisors Group, in which the SFBC participated, concluded that a particular regulatory focus should be placed on improving and managing risk management tools and valuation models for complex and illiquid financial instruments.

However, the collapse of Lehman Brothers and the severe difficulties of many banks to manoeuvre through the crisis in the fall of 2008 have led regulators worldwide to refocus their attention. The shift was towards improvement of supervisory systems, the improvement of the quality of and the increase in bank capital, regulation of liquidity in the financial system and last but not least the regulation of banker's compensation

As an initial reaction after the difficulties of the Swiss financial markets and in particular the support lent to UBS AG, most importantly by the Swiss Confederation acting through the Federal Finance Administration and the Swiss National Bank, on 20 November 2008, the SFBC imposed new leverage requirements on the two big Swiss banks and specified in some more details those components that may form regulatory capital.

2) FINMA has been shifting gears in 2009

Following this initial reaction there was, at least for some time, a relative quietness in the development of any new or additional regulations in Switzerland. But, that cannot serve as an indicator that there will be a relatively quiet period ahead in terms of regulatory developments. Quite to the contrary, the successor of the SFBC as of 1 January 2009, FINMA, made clear this summer that it works on various aspects of its financial markets regulation and in close coordination with foreign regulators, the recommendations of the G-20 (in which Switzerland was not a participant), as well as the Basel Committee. In fact, FINMA is expected to issue new regulations shortly and come up with new guidance as to regulatory capital aspects, liquidity planning, supervisory issues in relation to the *too-big-to-fail*-phenomenon, as well as compensation. Herein below we shall briefly analyze the regulatory initiatives that are currently on FINMA's agenda and the regulatory action that just have or are expected to be announced over the next few months in Switzerland.

3) FINMA's Focus on Bank Regulatory Capital and Leverage Ratios for the two big Swiss Banks

As of 1 January 2007, Switzerland implemented the Basel II framework, but with a so-called *Swiss finish*. The Swiss regulator already at that time decided that the Swiss banks will need to comply with higher standards than those laid out in Basel II, and it agreed with many banks individually on such higher standards or target rates. However, as developments in 2007 and 2008 showed, these extra measures have not proven to be enough, at least in the eye of the Swiss regulator.

The Swiss banking regulator felt that the losses of unheard proportions which banks encountered since the onset of the financial crisis in the summer of 2007 called for swift regulatory action. In close collaboration with the Swiss National Bank, the SFBC developed a new capital adequacy regime in the fall of 2008 which it felt would make the two large Swiss banks more resilient. The SFBC required in November 2008 that the two large Swiss banks comply with new capital adequacy ratios, in lieu of the previously applicable *Swiss finish* under Basel II, and new leverage ratio requirements by the year 2013. The new capital adequacy target will be in a range between 50% and 100% above the Pillar I requirements under Basel II. In addition, the decree includes leverage ratio requirements that require the banks to maintain by 2013 a ratio of core eligible capital to total assets (on a non-risk-weighted basis) of 3% at group level and at 4% for the individual institutions (see CapLaw-2009-8).

In line with general trends pursued within the Basel Committee, the Financial Stability Board, the Committee of European Securities Regulators (CESR), etc., FINMA is currently considering initiatives towards the further improvement of the quality of bank regulatory capital. The Vice-Chair of FINMA announced in mid September that FINMA is actively participating in the Basel Committee's discussions towards strengthening the quality of regulatory capital and is thus considering that while hybrid capital may have some merits, in the future it may again focus more on core equity components and thus may require banks to increase the core equity capital as opposed to the addition of new hybrid capital. In other words, it is anticipated that FINMA actively supports the Basel Committee's recommendations and may require the addition of regulatory capital in the form of common share capital or participation capital rather than by way of equivalents to the preference shares in the Anglo-Saxon world or some other forms of hybrid capital. It seems that the question is not whether or not tougher standards will be implemented, but rather when, in what form and how rigid new requirements will be formulated and what the grace period for the implementation of those new rules will be.

4) New Liquidity Requirements

In addition to improving quantity and quality of bank regulatory capital, FINMA is also focusing on improvements in respect of liquidity requirements. The SFBC and the Swiss National Bank already launched a project in 2007 focusing on the development on liquidity requirements on an institute-specific basis rather than on an industry-wide basis. These requirements that are currently still being developed will be based on perceived stress scenarios for liquidity gaps with given time horizons of between 7 and 30 days and will be subject to qualitative and quantitative requirements. A new liquidity requirement will then be imposed on a consolidated group level as well as on a solo level for the individual institutes within a group.

For internationally active banks, FINMA will require that the new Basel Committee-standards will need to be complied with. In essence, such banks will have to comply with a liquidity coverage ratio that should provide for a sufficient buffer in the form of non-earmarked, highly liquid assets which easily can be transformed into assets in order to support liquidity requirements during 30 days. In addition, such banks will need to comply with structural funding standards that are yet to be formulated and implemented.

5) Too Big To Fail

The developments of last year have demonstrated that the too-big-to-fail-phenomenon also materialized in Switzerland. Both the Swiss National Bank and FINMA have expressed their serious concerns about these developments and are working on ideas and schemes how to counter the *TBTF*-expectation in the market. Their aim is to protect the financial system and the Swiss economy at large from the dangers of a general TBTF-expectation and its inherent moral hazard, and to seek measures for the limitation of systemic risks associated with the TBTF-phenomenon. In that respect it may not be surprising if FINMA and the Swiss National Bank seek to impose additional prudential supervisory standards for systemically relevant banks such as the two Swiss big banks.

Recent discussions about how to best deal with the TBTF-phenomenon focused on how to best preserve the more relevant, in particular the strategically or systemically relevant parts of large banking groups. It is quite obvious that the definition of the systemically relevant parts is of utmost importance and strategically as well as politically sensitive, and that any such plans would need to be closely coordinated with regulators in those jurisdictions in which the respective big banks are active.

On 4 November 2009 the Federal Council announced the formation of a group of experts, composed of representatives of FINMA, the Swiss National Bank, the big banks, the financial industry and law as well as economy professors, to work out recommen-

dations for the regulatory approach towards big financial institutions in response to the TBTF-phenomenon.

6) Compensation Schemes

Following the international trend, in 2009 also the Swiss regulator started to focus on the sometimes utterly misplaced incentives that sometimes existed for employees in financial institutions to engage in very risky business for the benefit of their own pocket but at the risk and potential disadvantage of the financial institution. In early June, FINMA published a proposal for the regulation of compensation at financial institutions, which proposal was open for public comment until mid August. The proposal drew white-spread criticism and harsh opposition from the bigger banks in Switzerland.

With the new proposals, FINMA would have required all Swiss domiciled banks that are subject to the supervision of FINMA (with some minor exceptions) to draft new compensation rules that would need to be implemented until 1 January 2011. Moreover, FINMA intended to require that compensation schemes of banks must meet certain requirements, including in particular that:

- the compensation scheme complies in structure and amount with the risk policy of the financial institution and would further the risk awareness;
- variable components must be dependent on the long term economic profit of the financial institution, *i.e.,* may not just be based on short term profit considerations; and
- the compensation scheme must provide for the deferral of a portion of the compensation for at least three years, whereby the amount of the compensation that needs to be deferred shall be a function of the overall amount of the compensation granted.

On 11 November 2009 FINMA announced the release of the final version of its Circular on Remuneration Schemes (the Circular) with effect as of 1 January 2010. Until 1 January 2011, the Circular must be fully implemented and an audited report regarding the implementation of and compliance with the Circular must be submitted to FINMA until 30 April 2011 at the latest. FINMA has taken into account the results of the consultation process and of international developments, in particular the standards issued by the Financial Stability Board and other international bodies, and has made a few material changes to the original proposal:

- Generally, the Circular will only be mandatory for the largest banks and the largest insurance companies (calls for a limitation of the scope to the two largest banks have been dismissed) by requiring a minimal equity capital (banks) or solvency (insurance companies) of CHF 2 billion in order for the Circular to apply mandatorily;

- the linkage to economic profit has been replaced by economic performance, but this must reflect the full cost of capital and the risk profile of the institution; and
- commission models, while standard in the insurance industry, are covered by the Circular but clarification has been introduced that it is not the intention to make them impractical.

Other changes reflect the aim to leave the addressees with some flexibility in designing their compensation models. And notably, FINMA did not accede to the many requests to place absolute or relative caps on salaries.

7) Outlook

FINMA so far has applied some restraint in jumping to conclusions and adopting new, draconian regulations in response to the financial crisis. While its new capital and leverage ratios for the two big banks in November 2008 drew criticism from those two institutions, the general sentiment was that these requirements are justified and deserve support. In fact, a general international trend seems to move towards the adoption of leverage ratios. Whether the new regulations for compensation schemes announced on 11 November 2009 receives a similar generally supportive reception is open to debate. More importantly, it will generally be interesting to see whether FINMA will continue to pursue a rather balanced approach towards new regulation or whether it will again shift gears and move towards a "high-speed" implementation of new and aggressive rules and regulations. The author hopes, and calls again, that regulatory restraint will continue to prevail, and with the announcement of the new regulations for remuneration schemes it seems that FINMA tends towards such approach.

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International Administrative Assistance in Stock Exchange Matters

Reference: CapLaw-2009-76

In August 2009, the Swiss Financial Market Supervisory Authority (FINMA) has published a report that describes the international administrative assistance in stock exchange matters provided by Switzerland. The report reflects the active role of FINMA to respond to criticism expressed by foreign lobbyists with respect to certain Swiss rules on administrative assistance and suggests solutions that comply with Swiss procedural law.

By Petra Ginter

1) Introduction

International administrative assistance in securities matters serves as an important cross-border regulatory bridge between increasingly global activities of financial market players and national market supervision. While the global and multi-jurisdictional business of many banks and securities dealers (and their need to invest assets under management in large foreign capital markets) is generally not restricted by jurisdictions, effective market supervision and investigations are – as an act of state – usually restricted to the geographic boundaries of a national supervisor. Accordingly, statutory and regulatory provisions in a specific jurisdiction on mutual assistance are deemed to be an important instrument to facilitate effective (global) market supervision.

The roles of supervisory authorities in international co-ordination matters vary significantly from one country to the other. Some supervisory authorities, such as the US and other significant European countries, *i.e.,* primarily the supervisory authorities of important stock exchanges and liquid capital markets, on the one hand, usually request for international administrative assistance. On the other hand, countries like Switzerland and the UK, *i.e.,* countries in which many financial intermediaries as well as an important international clientele are domiciled, in most cases, are recipients of requests to provide international administrative assistance. Some countries require that financial institutions which act as securities dealers on their capital markets immediately disclose upon request the beneficial owner on whose behalf the trades were made. Accordingly, in case a financial institution is active on these markets, it should be in a position to immediately provide such information in order to avoid the risk of regulatory non-compliance as well as potential regulatory sanctions. As a consequence, it is argued that respective clients should contractually authorize the financial institutions to provide such information directly to the supervisory authority.

Article 38 of the Stock Exchange Act (SESTA) permits international administrative assistance in stock exchange matters, taking into account the interests of both, the foreign financial supervisory authorities and the clients affected by the administrative assistance.

2) Applicable Rules of Article 38 SESTA

Under article 38 SESTA (as amended in 2006), FINMA may provide administrative assistance to foreign supervisory authorities under certain conditions. In its August 2009 report FINMA provides guidance on its application of article 38 SESTA and its interpretation of certain key principles which can be summarized as follows:

- ***Request from competent foreign authority:*** The request must be lodged by a foreign authority that supervises stock exchanges and trading in securities as regulatory body (such as *e.g.,* the US Securities and Exchange Commission (SEC)) and the request for assistance has to be addressed to FINMA.

– ***No fishing expedition/principle of proportionality:*** The request must substantiate and specify the information sought and explain why such information is relevant for the foreign authority to supervise its stock exchanges and the trading in securities. In the field of insider trading, administrative assistance is provided if the foreign authority sufficiently shows a *first or prima facie suspicion,* which usually is deemed to be sufficient if, for instance, a trading in certain securities subject to higher volatility or volume is followed by an announcement such as a restructuring of the company. Information on third parties that are not related to the matter subject to the request *(unrelated third parties)* must not be transferred. According to precedents of Swiss courts, it is, for instance, sufficient that an account of a client was used for a doubtful transactions without knowledge of such client to disqualify such client as unrelated third party. FINMA's practice does, however, exempt clients with (written) discretionary asset management agreements from disclosure, subject to restrictive and clearly defined conditions (*e.g.,* the asset management agreement had been concluded long before the doubtful trades took place, the doubtful trades were made without knowledge of the client, and no other factor indicates that the client was involved in the trades). This exemption is considered a specialty of the Swiss administrative assistance system on stock exchange matters.

– ***Principle of confidentiality:*** Administrative assistance is only provided if the foreign supervisory authority is bound by authoritative or professional secrecy. The duty of a foreign supervisory authority to inform the public of its proceedings (so-called *litigation release*) does not frustrate the administrative assistance. Since the revision of article 38 SESTA in 2006, FINMA has, however, not been obliged to verify whether the (third party) authorities to which information is transferred (by the requesting foreign authority) do also comply with the principle of confidentiality. The former so-called *long arm principle (Prinzip der langen Hand)* according to which the Swiss Federal Banking Commission (SFBC) (today FINMA) was obliged to control and approve every additional transfer of information within the requesting (foreign) country (and, therefore, required for every additional transfer a specific request which could again have been subject to a *specific client procedure* (as described below under 3)), has been abandoned.

– ***Principle of specialty:*** Administrative assistance is only provided if the foreign supervisory authority will use the information exclusively to enforce (foreign) rules and regulations on stock exchanges, securities trading and securities dealers or for transferring such information for the specific purposes sought in the (original) request to other authorities, courts and bodies. On the one hand, since the revision of article 38 SESTA in 2006, the receiving (foreign) authorities have been authorized to transfer information to criminal authorities in order to prosecute offences against the financial market laws (insider trading, market manipulation, activity without respective license, operating fraudulent Ponzi schemes, etc.) without special or addi-

tional approval by FINMA. In other words, the transfer of information to third party authorities does not require a so-called *reciprocal criminal liability (doppelte Strafbarkeit)* any longer. On the other hand, the specialty principle prohibits to use the transferred information for tax purposes or to use the transferred information in the context of criminal procedures which are not associated with the financial markets supervisory law, without prior approval by FINMA and the Swiss Federal Office for Justice *(Bundesamt für Justiz), i.e.,* in order to use the requested information for such purpose, a dual criminal liability would be required.

Thus, the revision of article 38 SESTA in 2006 has already facilitated the administrative assistance in stock exchange matters with respect to two important points: (1) the foreign authority that has received information by FINMA may transfer such information also to third party authorities (including criminal bodies) for the exclusive purpose of enforcing (foreign) rules and regulations on stock exchanges, securities trading and securities traders; and (2) the foreign authority is permitted to use such information in enforcement procedures, even if the procedure of the authority will be published to a large extent.

3) Some Practical Aspects and Specific Problems

Control of the formal requirements by FINMA: Upon receipt of a request for administrative assistance in stock exchange matters, FINMA controls whether the formal requirements, namely the *specialty and confidentiality principles* as well as the existence of a *first suspicion,* have been met. In case these formal requirements are not fulfilled, FINMA returns the request to the requesting authority for amendment. In case the request lacks a first suspicion, FINMA rejects and informs the requesting authority, respectively. The test of first suspicion needs to be met in relation to the potential and alleged breach of law. The Swiss Federal Administrative Court *(Bundesverwaltungsgericht)* does not set the bar too high for the requesting (foreign) authority to show that the first suspicion has been met, because, usually, the investigating authority has just begun its investigations, and the Federal Administrative Court understands administrative assistance as a tool to support and not frustrate investigations conducted abroad. *E.g.,* in case a potential insider trading activity is investigated, it generally suffices that the transactions have been entered into within a period of time during which non-public information or events occurred that had an influence on the market price of the respective securities. It is, however, not a decisive factor whether the transactions have led to a profit or seem plausible with a view to the non-public information/event in question. In addition, the actual development of the market price and the transaction volume are perceived irrelevant. In case the formal requirements are fulfilled, FINMA forwards the request for administrative assistance (or, upon consultation with the requesting authority, a respective summary without disclosing any confidential information on the foreign investigation) to the relevant securities dealers.

Duty to inform and report to FINMA: Persons and entities that are supervised by FINMA must provide FINMA with all information and documents that it requires to carry out its tasks, including international administrative assistance (article 29 and 42 (2) Financial Market Supervisory Authority Act (FINMASA)). Any person that provides false information to FINMA is subject to criminal sanctions (article 45 FINMASA) and may also be exposed to administrative sanctions. Even entities that are not subject to FINMA supervision, such as independent asset managers or private investors, are obliged to provide information to FINMA which are necessary to provide administrative assistance to the requesting (foreign) authority. This practice corresponds to the purpose of SESTA to supervise not only stock exchanges and securities dealers, but the financial markets in general. At this stage of procedure, FINMA prohibits the addressee of the request to inform potentially affected clients of the administrative assistance.

Institution-related vs. client-related information: FINMA differentiates between information concerning the supervised financial institution as such, its proprietary trading, its organization, bodies and employees (so-called *institution-related information*) and information that relates to a specific client (so-called *client-related information*). Whereas institution-related information can be transferred to the requesting authority without formalities if the legal requirements for the administrative assistance are fulfilled, client-related information is subject to the *specific client procedure*. To provide clients with certain procedural rights in the context of an international administrative assistance procedure is a specialty of Swiss administrative law compared to most other countries. Accordingly, the Federal Act on Administrative Procedures *(Bundesgesetz über das Verwaltungsverfahren (VwVG))* applies in case the transferred information contains particular *client data*. As a consequence, FINMA is required to inform the respective clients on the administrative assistance procedure as well as on its right to request a formal decision by FINMA (costs are up to CHF 15 000) if the client refuses such transfer of information to the (foreign) authority. Such FINMA decision can be challenged before the Federal Administrative Court within ten days upon receipt (as final court of appeal). The client procedure is highly controversial on an international level, in particular, because it requires disclosure of the request for administrative assistance to the affected client and, accordingly, may imply the risk of collusion and loss of evidence. Although precedent suggests that the success of an appeal is very low (since 2002 no appeal has been approved), it is not unusual that affected clients use this legal remedy. Therefore, FINMA is considering to withdraw the *suspensive effect (aufschiebende Wirkung)* of the appeal for clear-cut cases, and to petition the Federal Administrative Court to uphold this decision. If the client agrees with the transfer of information, FINMA forwards the information to the requesting (foreign) authority.

Defense of the affected clients: The investigations that are underlying the administrative assistance request are carried out abroad and concern a foreign market. FINMA neither has the resources and funds nor the legitimation to control whether the person affected by the administrative assistance has actually violated foreign rule or regulations. The role of FINMA is limited to the control of the formal requirements as described above.

4) Some Closing Comments

FINMA considers article 38 SESTA as a balanced and workable compromise between an efficient administrative assistance to foreign supervisory authorities, on the one hand, and the observance of the procedural rights of a client being affected by the administrative assistance, on the other hand. Yet, FINMA mentions in its report that the current wording of article 38 SESTA has caused criticism from some foreign supervisory authorities and lobbyists because of the special features of the Swiss administrative assistance as mentioned above, mainly the duty to inform the affected person prior to the transfer of respective client-information to the requesting (foreign) authority. This criticism has also led FINMA not to sign the Multilateral Memorandum of Understanding enacted by the International Organization of Securities Commissions (IOSCO) at this stage. With respect to the mentioned concerns, FINMA is currently analyzing possible means, available within the boundaries of applicable law, to delay the information of the client in clearly defined cases (exemptions) in order to avoid the risks of collusion or loss of evidence.

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Eliminating Broker Discretionary Voting for Director Elections – Impact on Foreign Private Issuers

Reference: CapLaw-2009-77

The US Securities and Exchange Commission recently approved an amendment to the New York Stock Exchange Rule 452, eliminating broker discretionary voting for director elections. This amendment, which will come into effect on 1 January 2010, has no impact on foreign private issuers.

By Thomas Werlen / Stefan Sulzer

On 1 July 2009, the US Securities and Exchange Commission approved the New York Stock Exchange's (NYSE) amendment to Rule 452 (Giving proxies by Member Organizations), eliminating the ability of brokers to vote in their discretion with respect to elections of directors.

1) Current NYSE Rule 452

Under the current NYSE Rule 452, brokers are required to deliver proxy materials to the beneficial owners of shares and request instructions on voting. If the instructions are not returned by the tenth day before the date of a meeting, the broker may vote on behalf of the beneficial owners with respect to certain "routine" matters. NYSE Rule 452 currently lists 18 items that are considered "non-routine", including items such as shareholder proposals opposed by management, and mergers or consolidations.

2) The Amendment

The amendment to NYSE Rule 452 adds "the election of directors", whether contested or uncontested, to the list of matters on which brokers that are members of the NYSE are not permitted to give a proxy to vote without instruction from the beneficial owner (new NYSE Rule 452.11(19)). In its report, the Proxy Working Group (PWG), a committee formed by the NYSE to review the proxy voting process, pointed out that the election of a director, even where the election is uncontested, is not a routine event in the life of a company. Directors are simply too important to the company for their election to ever be considered routine (Report and Recommendations of the Proxy Working Group to the New York Stock Exchange, 5 June 2005, page 21, available at http://www.nyse.com/pdfs/PWG_REPORT.pdf).

The amendment to NYSE Rule 452 will be applicable to proxy voting for shareholder meetings held on or after 1 January 2010.

3) Implications

The majority of publicly traded shares are not registered in companies' records in the names of the beneficial owners. Instead, an estimated 70 to 80 percent of all public companies' shares are held in "street name", meaning that they are held of record by brokers, banks or their depositories (PWG Report, page 10, see above).

The amendment to NYSE Rule 452 is designed to ensure that persons with an actual economic interest in a company vote to elect directors because the problem with broker voting is that it allows someone (*i.e.*, the broker) who does not have an economic interest in the company the opportunity to vote on the company's business.

The inability of brokers to vote uninstructed shares in director elections will, however, diminish the votes of retail shareholders disproportionately. Unlike institutional shareholders, relatively few retail shareholders – less than 20 percent in 2008, according to Broadridge – vote their shares (Broadridge, Statistical Overview of use with Beneficial Shareholders as of 30 June 2009, available at http://www.broadridge.com/notice-and-access/NAStatsStroy.pdf). The impact of retail shareholder inaction was traditionally mitigated by the ability of brokers to vote in uncon-

tested director elections and other routine matters. Historically, brokers have generally cast uninstructed shares overwhelmingly in support of the board's recommendations, which provide a significant advantage to the incumbent board in director elections and other matters. As a result, directors of companies that have a significant retail shareholder base and that have adopted a majority voting policy may find it harder under the amended NYSE Rule 452 to achieve the requisite majority of votes. Conversely, in the face of a fall in retail shareholder voting, institutional investors and activist shareholders will find the power of their votes enhanced.

Also, while the amendment to NYSE Rule 452 is likely to result in some greater costs and difficulties for companies, as they will have to spend more money and effort to reach shareholders who previously did not vote, these costs are – according to PWG – required to be paid for better corporate governance and transparency of the election process (PWG Report, page 21, see above).

4) No Impact on Foreign Private Issuers

The amendment has no impact on foreign private issuers because the current NYSE Rule 452 already deems all votes at their shareholder meetings to be "non-routine" since they are not subject to US proxy rules.

In other words, even under the current NYSE Rule 452, brokers that are members of the NYSE cannot exercise discretionary voting on any agenda item of a foreign private issuer shareholder meeting. The amendment to NYSE Rule 452 by re-qualifying director elections as "non-routine" proposals has therefore no impact on foreign private issuers.

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Takeover Board Grants Exemption from Duty to Make an Offer in Implenia AG Case to Credit Suisse AG

Reference: CapLaw-2009-78

On 16 November 2009, the Takeover Board granted Credit Suisse AG an exemption from the duty to make an offer to the shareholders of Implenia AG in connection with the envisaged exit of Laxey Partners Ltd. and the investment vehicles managed by it (Laxey). Notably, the exemption was not based on article 38 of the FINMA Stock Exchange Ordinance pursuant to which a general exemption exists if banks or securities dealers make a firm underwriting and notify the Takeover Board that they rely on the general exemption. This general exemption only exists for firm underwritings in con-

nection with an issue of equity securities and an undertaking to resell. The Takeover Board's reasoning was mainly based on the fact that Credit Suisse AG's holding of the Implenia AG shares obviously is of very short term nature. At the time of the settlement of the share purchase from Laxey, Credit Suisse AG will have concluded sale contracts regarding all Implenia AG shares acquired by it which will settle the very same day. Credit Suisse AG will hold no shares in Implenia AG after the deals will be closed on this day. Interestingly, the Takeover Board rejected Credit Suisse AG's argument that Credit Suisse AG does not qualify as the beneficial owner of the Implenia AG shares as irrelevant. According to the Takeover Board, the question of beneficial ownership only arises in the context of indirect holdings.

Furthermore the Takeover Board stated that Credit Suisse AG is neither forming a group with Laxey nor with the purchasers of the Implenia-stake. Credit Suisse AG will not act in concert with Laxey or the investors with a view to exercise control over Implenia AG.

The Takeover Board further acknowledged the absence of a duty to make an offer for the purchasers, if none of them individually exceeds the threshold of 33⅓% of the voting rights of Implenia AG. The investors acquire the Implenia AG shares in their own name and on their own account, do not coordinate their conduct, neither with respect to the exercise of voting rights nor otherwise, and do not have the intention to exercise control on Implenia AG.

FINMA Closes Investigation in Sulzer AG Case Regarding Breach of Disclosure Obligations

Reference: CapLaw-2009-79

On 3 November, the Swiss Financial Market Supervisory Authority FINMA (FINMA) released that it finally closed its comprehensive investigation into the Sulzer AG case regarding the alleged breach of disclosure obligations under the Stock Exchange Act on 30 October 2009 after investigating for more than two years. The investigation was prompted by a notice at the end of April 2007 which disclosed that Everest Beteiligungs GmbH held a stake of more than 31%, consisting of almost 18% in equity and about 14% in formal cash settlement options, in Sulzer AG without previously meeting their legal disclosure obligations.

Along with the proceedings against the investors, FINMA and previously the Swiss Federal Banking Commission examined the role played by the banks which were involved in the Sulzer AG stake building. FINMA decided that the involved banks in part seriously breached their legal duties while issuing and trading Sulzer AG secu-

rities. FINMA clarified that under current practice, the economic background of an intended transaction on behalf of clients must be clarified if there are indications that the transaction may be part of an illegal or immoral scheme or if the transaction is complex, unusual or significant. The management of banks or securities dealers must compile all documentation related to risky transactions which is necessary for decision making and supervision. This documentation must enable a specialist third-party (*e.g.,* an auditor) to come to a reliable conclusion about the transaction. According to FINMA, the amount of the transaction, unusual dealings and not least the willingness of a client to offer a bank considerable compensation for its services are at any rate signs which should prompt banks to further clarify the situation. A clarification of the economic background is also substantially necessary for risk assessment (*e.g.,* reputation risk) from a material perspective. If banks neglect to perform this clarification and review, they assume the risk of becoming involved in or financing business with an objectionable purpose. FINMA stated that banks may carry out unusual transactions, provided they exercise due diligence and ensure the proper conduct of business. However, they must first clarify the situation and compile the documentation required in such a case, develop an informed opinion about the intended transaction and, based on this, also abstain from conducting a transaction which has been deemed to be potentially illegal.

ING Bank (Switzerland) Ltd. acquired by Julius Baer Group Ltd.

Reference: CapLaw-2009-80

On 7 October 2009, ING Bank Luxembourg S.A. and Julius Baer Group Ltd. announced that they have concluded an agreement according to which Julius Baer Group Ltd. will be acquiring ING Bank (Switzerland) Ltd. for CHF 520 million in cash, including surplus capital of CHF 170 million. ING Bank (Switzerland) Ltd. offers a comprehensive range of services and products, such as discretionary and advisory portfolio management based on open architecture as well as family office, trust and execution services. Pending regulatory approvals, closing of the transaction is expected to take place in the first quarter of 2010.

Petroplus raises CHF 850 million in three financing transactions

Reference: CapLaw-2009-81

On 9 September 2009, Petroplus Holdings AG, Europe's leading independent refiner and wholesaler of petroleum products, announced three capital markets transactions consisting of (i) an offering of USD 400 million 9.375% Senior Notes due 2019, (ii) an offering of USD 150 million 4.00% Convertible Bonds due 2015, and (iii) a fully underwritten equity offering by a syndicate of banks with subscription rights granted to existing shareholders by issuing 17,265,058 registered shares with gross proceeds of over CHF 290 million.

The proceeds of the High Yield Transaction and the main part of the proceeds of the Convertible Bond Transaction were used to finance a cash tender offer for the existing USD 500 million 3.375% convertible bonds issued by Petroplus Finance Ltd, which was launched on 11 September 2009 and closed on 16 October 2009. Further, the holders of the USD 500 million 3.375% convertible bonds approved an amendment to the terms and conditions of the convertible bond in an extraordinary bondholders' meeting which was held on 13 October 2009 which allowed Petroplus Finance Ltd. to redeem the convertible bonds which were not tendered in the tender offer with three days' notice. This early redemption also occurred on 16 October 2009.

EUR 2 billion Inaugural Issuance under the UBS Covered Bond Programme

Reference: CapLaw-2009-82

On 6 October 2009, UBS closed its EUR 2 billion inaugural issuance under its Covered Bond Programme established in September 2009. The Covered Bonds were issued by UBS AG, London Branch and are guaranteed by UBS Hypotheken AG. The Covered Bonds issued under the Programme are indirectly backed by a portfolio of mortgages from UBS AG's domestic mortgage pool.

4th Annual Meeting Sessions on Corporate Governance, Regulation, Swiss Banking Industry and Global Financial Markets

Zurich, 20 November 2009

Swiss Finance Institute, annual-meeting@sfi.ch
http://www.SwissFinanceInstitute.ch

Kapitalmarkttransaktionen V (Capital Markets Transactions V)

Zurich, 26 November 2009

Europa Institute at the University of Zurich, eiz@eiz.uzh.ch
http://www.eiz.uzh.ch

Entwicklungen im Recht der kollektiven Kapitalanlagen IV (Developments in Collective Investment Schemes Legislation IV)

Zurich, 1 December 2009

Institut für Rechtswissenschaft und Rechtspraxis, University of St. Gallen and Swiss Funds Association, SIX ConventionPoint, Zurich, irp@unisg.ch
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