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Annual Report 2009 of the Disclosure Office of the SIX Swiss Exchange—Relevant Decisions

Reference: CapLaw-2010-40

In June 2010, the Disclosure Office (DO) of the SIX Swiss Exchange Ltd. published its annual report for the year 2009. In addition to publishing statistics and highlighting specific issues that came to the DO's attention, the annual report mainly serves the purpose of publishing the DO's decisions in relation to questions of Swiss disclosure law, in particular article 20 of the Stock Exchange Act (SESTA). The following contribution will highlight certain aspects which the author considers to offer new or relevant aspects in the Swiss disclosure law.

By Benjamin Leisinger

In its introduction, the annual report of the DO states that while it submitted 106 complaints to the Swiss Financial Market Supervisory Authority FINMA (FINMA) with respect to the violation of Swiss disclosure law (be it negligent or intentional), to the DO's knowledge, in no event FINMA submitted the complaint to the Federal Department of Finance that, based on article 50 of the Swiss Financial Market Supervisory Act (FINMASA), would be responsible for prosecution and sanctioning of violations of the criminal provisions relating to such disclosure laws. The DO maintains that the reasons for such refusal to enforce the law are unknown to it, but it asserts that it is important that both intentional and negligent violations of Swiss disclosure rules are actually prosecuted and sanctioned. Against this background, the understanding of Swiss disclosure law and the lessons learned from the DO's decisions in the last year become even more important.

1) "Justified Cases" According to Article 24 SESTO-FINMA

According to article 24 of the FINMA Stock Exchange Ordinance (SESTO-FINMA), exemptions from or easing of the obligation to notify the DO and the respective company may be granted in "justified cases". One situation where a justified case could be at hand is where the transaction is subject to conditions (article 24(1)(a) SESTO-FINMA).

Cases published by the DO in its annual report deal with the requirements that must be met in order for conditions qualifying as a justified case. In the cited cases, the DO found that conditions were undisputedly at hand. However, it clarified that not every condition can automatically justify an exemption under article 24 SESTO-FINMA. Whether a justified case indeed is at hand, according to the DO, must be mainly analyzed based on the interests of the market participants. The DO stated that in cases where the information with respect to the specific transaction is known to the public from other sources (*e.g.* through dissemination in the media), the requirements for obtaining an exemption or an easement with respect to the disclosure are less strict.

In any case, it clarified that the mere fact that the transaction was subject to the non occurrence of a "material adverse change" does not suffice to justify an exemption.

When discussing whether the publication of the disclosure would be misleading to the market, the DO stated that in its view, the public and in particular experienced investors can understand even complex facts.

2) "Financial Instruments" According to Article 15 SESTO-FINMA

Pursuant to article 15 SESTO-FINMA, financial instruments are subject to a disclosure obligation, *i.e.,* they must be taken into account when calculating the thresholds set forth in article 20 SESTA. This provision provoked several complex questions.

a) Guaranteeing a Minimum Price in Case of Accelerated Bookbuilt Offerings

A case discussed in the annual report reminds investors (or sellers) that certain agreements and arrangements in transactional documents could lead to the existence of a cash settled financial instrument even where this is not obvious in the beginning.

In this case, the banks guaranteed a certain minimum purchase price to the investor on whose behalf they planned to sell the shares on the market by means of an accelerated bookbuilding offering. By their arrangements, they took away the investor's commercial risk with respect to a low purchase price and, simultaneously, would benefit if the shares are sold above this minimum price by getting remunerated by an additional placement fee. The banks' intention was only to give comfort to the seller by paying a certain minimum amount irrespective of the price established in the accelerated bookbuilt and not to acquire the shares themselves. This situation, the applicants stated, was not different to a case of a firm underwriting where exemptions from the obligation to notify are granted under certain circumstances.

The DO stated that while the situation would be similar to a firm underwriting, a cash-settled financial instrument existed by this arrangement. In this case, certain additional details would normally have to be published based on article 21 SESTO-FINMA, *e.g.,* the subscription ratio or the exercise price. When assessing whether an exemption could be granted in the specific case, the DO again weighed the interest of the public and the high level of publicity from other sources in the context of the specific case on the one hand against the interest of the applicants, on the other hand, and, granted an exemption.

b) Convertible Bonds

In a further case, the DO clarifies that convertible bonds (in contrast to straight bonds) qualify as financial instruments within the meaning of article 15(1) SESTO-FINMA, irrespective of the conditions for the conversion right.

In the specific case, the conversion right of the bonds was subject to certain conditions such as, in particular, the listing of the issuer's shares and the share price having a VWAP of a specific amount in Swiss francs on 20 out of 25 consecutive trading days. While the shares in question had been listed (otherwise article 20 SESTA would not be applicable), the share price was far away from the required level. The DO, applying an economic analysis and also referring to Swiss corporate law, held that it was irrelevant whether or not conversion was realistic. Accordingly convertible bonds qualify as financial instruments that are subject to a disclosure obligation from day one irrespective of any conditions for such conversion.

3) Disclosure by "Foreign Collective Investment Schemes" and Article 17 SESTO-FINMA

Other cases published by the DO again deal with the disclosure by foreign collective investment schemes and the impossibility to obtain the confirmation from the home regulator with respect to the independence of the collective investment scheme. Only where (i) evidence is provided in advance that the respective collective investment scheme is independent from the group of companies and (ii) provided that this proof is confirmed by the competent supervisory authority, *i.e.,* the home regulator, foreign collective investment schemes not authorized by FINMA for public distribution in Switzerland may fulfil their disclosure obligations in the same (eased) way as authorized collective investment schemes.

In these cases, the applicant could show that both, legally and factually they are independent from their parent undertakings with regard to (i) organization, (ii) investment decisions and (iii) the exercise of voting rights.

If foreign collective investment schemes cannot rely on article 17 SESTO-FINMA, they could still request and exemption based on article 24 SESTO-FINMA. In contrast to an exemption under article 17 SESTO-FINMA available to authorized collective investment schemes, however, the exemption under article 24 SESTO-FINMA does not automatically apply but must be requested from the DO in advance (15 trading days before crossing a threshold, taking FINMA's possibility to attract the case into account). Furthermore, if granted, the exemption is limited with regard to the duration. Moreover, the exemptions based on article 24 SESTO-FINMA can be and normally are subject to conditions. In the published cases, one condition, for example, was that there is no violation of the independence. In case of such violation the exemption would automatically be void. Additionally, the exemption was subject to the condition that there was no coordination with regard to the major Swiss shareholdings between the applicant, the parent undertakings or any other companies of the group of companies. In case of such coordination, the exemption would also be void.

One published decision was attracted by FINMA and a decision by FINMA was not reached until the completion of the annual report.

These cases again show that the provisions set forth in the SESTO-FINMA with respect to disclosures by foreign collective investment schemes do not make sense because home regulators do not give the required evidence. A solution, for example by revising article 17 SESTO-FINMA, would be most welcome.

4) "Acquisition Groups" Pursuant to Article 10(2)(a) SESTO-FINMA

Based on article 10(2)(a) SESTO-FINMA, coordination of conduct leading to an obligation to disclose as group, *e.g.,* exists in cases of legal relationships for the acquisition or sale of equity securities.

In a decision published by the DO, it again clarified that in the case of an acquisition group, such acquisition has to occur from a third party. In general (*i.e.,* in the absence of other arrangements such as, for example lock-up agreements), the mere acquisition or the sale of equity securities among the parties of a sales contract with respect to these equity securities never leads to the composition of the group between the seller and the purchaser.

5) General Conclusion

The mere length of the annual report of the DO shows that Swiss disclosure law is getting more complex and more important for investors.

While the annual report of the year 1999 was only 8 pages long, 10 years later the annual report counts 100 pages. This, however, is not only due to the complexity of Swiss disclosure law, but is a demonstration by the DO of its goal to enhance legal certainty by publishing its decisions. While FINMA stopped publishing its decisions in bulletins, the DO accepts the necessity of transparency and the importance of providing the market and its participants with the pertinent information. Only where the decisions are published, the investors are in a position to learn how certain provisions in the law are understood and applied by the authorities. In addition to enhancing legal certainty, market transparency guarantees the quality of the decisions, because arbitrary decisions could become subject to public debate.

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Better Safe than Sorry—Analysing the Federal Supreme Court's Implenia-Decision of 11 March 2010

Reference: CapLaw-2010-41

On 11 March 2010, the Federal Supreme Court put an end to a long lasting and complicated legal battlefield with regard to disputed violations of disclosure obligations of Laxey prior to its unsuccessful takeover attempt of Implenia. The Supreme Court's decision on the two underlying and unified proceedings 2C_77/2009 and 2C_78/2009 provides for a new definition of the catch-all term "indirect acquisition" and will be read with particular interest by the prosecutors in the now resurrected administrative penal proceedings.

By Eva R. Selamlar-Leuthold

1) Secret Stake Building through "Contracts for Difference"

Implenia Ltd (Implenia) is a Swiss based share corporation active in the fields of real estate and construction work. In April 2007, Implenia suspected Laxey Partners Ltd (Laxey), an off-shore investment company, along with concerted parties, not to have complied with its statutory duty to notify Implenia about acquired shareholdings and informed the Swiss Federal Banking Commissioon (FBC) (today the Swiss Financial Market Supervisory Authority FINMA (FINMA)) about its suspicion (article 20 (1) and (4) Stock Exchange Act (SESTA). Indeed, only a few days later, Laxey announced that it held no longer 4.4% of Implenia shares as in December 2006 (where holdings below 5% did not yet have to be notified), but approximately 23%. According to Laxey, no acquisitions were made until April 2007 when the announcement was made and thus no disclosure obligations violated. But how could Laxey achieve such a substantial holding within a few days only?

It became clear that long before disclosing its substantial holding of 23%, Laxey concluded so called "contracts for difference" (CFDs) with different banks that had Implenia stock as underlyings. The characteristics of these CFDs and the legality of Laxey's approach occupied not only the authorities, but the Swiss doctrine and the public for a long time afterwards. In short, Laxey and the banks as CFD issuers had a deal that upon termination of the CFD they must pay each other, depending on the development of the Implenia stock rate, the difference to the price agreed when concluding the CFD. The banks then bought at a 1:1 ratio underlying Implenia shares to hedge their risk. Implenia shares in the amount of 18.6% were thus blocked. The CFDs did not oblige the banks to deliver the underlying shares to Laxey when the CFDs were terminated (no actual delivery obligations).

2) Proceedings' Overview

In October 2007, based on article 20 (6) SESTA, Laxey requested the FBC to preliminarily decide *(Vorabentscheidverfahren)* if Laxey's conclusion of the CFDs was subject to a disclosure obligation under article 20 (1) SESTA. The FBC ruled in the affirmative. Laxey appealed against this decision to the Federal Administrative Court and thereafter to the Supreme Court (docket no. 2C_78/2009), though—as now seen—without success.

In January 2008, the FBC initiated a formal administrative proceeding *(formelles Verwaltungsverfahren)* and decided in March 2008, that Laxey violated its disclosure duties under article 20 (1) SESTA and that Implenia had party rights in the proceedings. According to the FBC, Laxey had factual control over substantial Implenia holdings when concluding the CFDs at the end of 2006/in early 2007 and thus ought to have reported the triggered thresholds of 5%, 10% and 15% at the time when concluding the CFDs. Laxey took this decision to the Federal Administrative Court as well and thereafter to the Supreme Court (docket no. 2C_77/2009). Again without success.

Both proceedings were unified by the Supreme Court, which *inter alia* confirmed in its intermediate decision of 2 June 2009 that Implenia has party rights in the formal administrative proceeding—contrary to the preliminary investigation proceedings *(Vorabklärungsverfahren)* where according to the Supreme Court generally no party rights are granted, neither to the involved company nor to its shareholders who are in alleged breach of their disclosure obligations.

In April 2008, the Finance Department initiated administrative penal proceedings against the economic owners and other responsible persons of Laxey due to a suspected breach of disclosure obligations (article 41 SESTA in connection with article 20 SESTA). The administrative penal proceedings were suspended until the Supreme Court ruled on the matter and are now taken up again.

Prior to the Supreme Court's ruling, Laxey sold its majority stake in Implenia. After all, the takeover bid by its subsidiary LIL Investments No. 4 Limited in November 2007 was not successful and even though Laxey held at the end 52% of Implenia stock, it could only vote as a 4.9% shareholder due to Lex Koller law limiting a real estate company from being controlled by foreign shareholders.

3) Discussion of the Supreme Court's Decision

a) Party's Right to a Court Decision: Yes as to Alleged Breaches of Law—No as to Pro Futuro Assessments

The Supreme Court elaborated that despite the fact that Laxey is no longer a shareholder of Implenia, Laxey still has an interest to know whether it violated Swiss law or not, in particular with a view to the concerned persons' business reputation. The deci-

sion that someone is in breach of disclosure obligations is, according to the Supreme Court, equivalent to a reprehension *(Rüge),* which the concerned party must be able to object to. Further, according to the Supreme Court, Laxey has a legitimate interest to know what its exact legal obligations were since the lower instances' decisions, though not binding for the administrative penal proceeding, are nevertheless the basis for it.

The Supreme Court further compared the wordings of article 20 SESTA prior and after the revision of 1 December 2007. In the court's view, the proceeding 2C_78/2009 (preliminary decision that article 20 (1) SESTA applies) can be merged into the proceeding 2C_77/2009 (breach of article 20 (1) SESTA) at least to the extent that both proceedings have the same shareholdings as subject matter and provided that such holdings were acquired prior to 1 December 2007, which was both the case. Laxey's request to the Supreme Court to rule on Laxey's disclosure duties in view of new article 20 (2bis) SESTA, which entered into force on 1 December 2007, was rejected by the court: a party's interest to have the court assessing the legal situation theoretically and *pro futuro* is not worthy to be protected.

b) Low Standard of Evidence for Authorities: Anticipated Conclusions are Allowed

Laxey claimed that the FBC has not thoroughly examined all underlying CFD transactions and that thus the FBC/the Federal Administrative Court did not have all the necessary facts for deciding. However, since Laxey failed to show how the CFD transactions that were not examined by the FBC would have had an impact on the outcome of the lower instances' assessment, the Supreme Court rejected the argument by referencing a court's general right to assess a very complex case by way of anticipated conclusions which are derived from detailed examinations of individual transactions *(antizipierte Beweiswürdigung).* The Supreme Court, however, requested that the anticipated conclusions do not raise any doubts and that nothing speaks against such an approach. In the court's view, Laxey also failed to show that there are any such objecting reasons.

c) High Standard of Evidence for Involved Parties: Detailed Proof Required

Laxey argued that in the preliminary investigation proceeding, *i.e.,* when FBC made inquiries with foreign authorities and third parties before opening the formal administrative proceeding, it was not granted the constitutional right to independently question itself said foreign authorities or informants. The Supreme Court stated again that as a rule no party rights are granted in preliminary investigation proceedings, but only later when formal administrative proceedings are initiated. It further stated that the question whether Laxey has indeed a right to confront an informant by way of analogy to a defendant's right to question a witness *(Zeuge)* can remain open since the FBC did not question the foreign authorities and third parties as witnesses, but as informants

(Auskunftspersonen). Further, in the court's view, Laxey had the opportunity to extensively comment on all informants' statements as soon as the formal administrative proceeding was initiated and Laxey failed to show in detail which additional authorities or informants ought to have been questioned and which exact questions ought to have been asked.

As seen, the court stated that party rights are—as a rule—only available as soon as formal administrative proceedings are initiated. This leads to the conclusion that if the involved parties want to claim undue lack of party rights, they need to prove that the authorities should have initiated the formal administrative proceedings at an earlier point of time. This is a difficult task. Also, the court ignored the risk that FINMA might make up its mind while conducting the preliminary investigation proceedings and that granting party rights in the following formal administrative proceedings does hence not have the same impact since FINMA may have drawn its conclusions already (interestingly, FINMA initiated the formal administrative proceedings in January 2008 and expediently decided the case in March 2008).

d) "Indirect acquisition" as a Catch-All Term

Laxey took the position that prior to 1 December 2007, the indirect acquisition of shares by way of CFDs without actual delivery *(ohne Realerfüllung)* was not caught by article 20 SESTA since its para. 2bis, which the legislator created as a direct consequence of the Laxey/Implenia case, was not yet in force. The Supreme Court consequently analysed the legal term "indirect acquisition" as stated in the ordinance prior to 1 December 2007:

Article 9 (3) of FBC's Stock Exchange Ordinance (SESTO-FBC, now SESTO-FINMA) stated four categories of indirect acquisitions and further in sec. d, that in particular *'all transactions that, as a result, potentially provide the acquirer with voting rights of the shares'* (with one exception that is of no interest here) are deemed indirect acquisitions. Further, article 13 SESTO-FBC set forth that derivatives providing for actual delivery are caught by the disclosure regime.

The Supreme Court conceded that CFDs without actual delivery were not explicitly caught by the SESTO-FBC in its old version. It followed though by saying that this alone is not decisive and that the ordinance must be interpreted in light of the overall purpose of SESTA, *i.e.,* transparency, market efficiency and equal treatment of investors. Already prior to 1 December 2007, the legislator had recognized that the financial markets were creative and invented new financial instruments by the day. Not to always be a step behind, the legislator chose a broad (yet legally sufficient and precise) wording when describing the term "indirect acquisitions" in article 9 (3) SESTO-FBC as a catch-all provision. CFDs without actual delivery were thus already caught by the disclosure regime as in force prior to 1 December 2007: Inserting article 20 (2bis) SESTA

did not extend the substance or scope of the former disclosure regime, but simply clarified the existing rules. In the court's view this is also in line with article 15 (1) SESTO-FINMA (SESTO-FINMA replacing SESTO-FBC on 1 January 2009), which now explicitly states that CFDs—with or without actual delivery—are subject to disclosure.

e) New definition of "indirect acquisition"

According to the Supreme Court, the term "indirect acquisition" catches *'all business activities which, despite the fact that the formal ownership may be different from the beneficial ownership, reasonably allow someone to build up a threshold triggering shareholding (or provide, as a result, the according voting rights), if under the circumstances one has to conclude that a controlling stake is indeed the ultimate goal of the acquirer'.* What counts is that a shareholding is or could be built *(objective element),* which is a factual and not a legal issue. Second, the acquirer must intend such result *(subjective element).* The intention's existence is derived from the surrounding circumstances (*i.e.,* shareholder becomes active, goes beyond the stage of planning).

As to the objective element, Laxey put forward that there was no legal obligation of the CFD issuers to actually deliver the underlying Implenia shares to Laxey. The Supreme Court conceded that this may be true, however not relevant due to the factual connection between the blocked shares and the CFDs: After the CFDs were terminated by Laxey, the CFD issuers no longer needed the underlying shares which were previously acquired for hedging purposes and, in particular since the shares were too many in size to be sold on the exchange, it was evident to give these shares to the most obvious and willing buyer (*i.e.,* Laxey). Laxey could rely on exactly this and based its strategy thereon.

As to the subjective element, Laxey argued that it did not intend to build up a controlling stake but merely wanted to hedge its investments after it became clear that the European construction industry did not develop as expected. The court was not convinced: The entire behaviour (primarily Laxey's parallel and coordinated purchases) cannot be interpreted other than that Laxey was aiming for a substantial shareholding.

4) Outlook

According to the Supreme Court, party rights are—as a rule—only available as soon as formal administrative proceedings are initiated. Practice will yet have to show what the exceptions are. Based on the inherent risk that FINMA makes up its mind while conducting the preliminary investigation proceedings, exceptions should be granted generously.

Whether the Supreme Court will stick to its new and more precise definition of "indirect acquisition" with both its objective and subjective elements cannot yet be told, in particular since the decision is based on law provisions no longer in force (though the term "indirect acquisition" has not been affected by the law revision). Still, so far, the intention of an acquirer was only relevant in the context of determining whether an acquirer acts in concert and aims for control of a company, and not in the context of assessing indirect acquisitions. Sure thing though is that an acquirer, if uncertain whether (1) the planned acquisition could reasonably allow him or her to build a threshold triggering shareholding or provide as a result the according voting rights and (2) an outside person could conclude from the circumstances that such stake building is indeed the goal, the acquirer is well advised to obtain a preliminary decision by the Stock Exchange's Disclosure Office and FINMA (as second instance), respectively, under article 20 (6) SESTA and article 20 SESTO-FINMA. Due to the catch-all nature of the term "indirect acquisition", the acquirer will not be successful in bringing forward that a financial instrument is new in Switzerland and that it was uncertain if it is subject to a disclosure duty. Better be safe than sorry, the Supreme Court says.

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Update of Position Paper on International Offerings of Equity Securities in Switzerland by non-Swiss Issuers—Swiss Prospectus Requirements

Reference: CapLaw-2010-42

As per 15 June 2010, the firms supporting the *Position Paper on International Offerings of Equity Securities in Switzerland by non-Swiss Issuers—Swiss Prospectus Requirements* updated it and added a suggested disclaimer for non-public offerings of plain vanilla shares of corporates.

By Credit Suisse AG / UBS AG / Bär & Karrer AG / Baker & McKenzie / Homburger AG / Lenz & Staehelin / Niederer Kraft & Frey AG / Pestalozzi Attorneys at Law Ltd / Schellenberg Wittmer / Vischer AG / Walder Wyss & Partner AG

Following the publication of the Position Paper on International Offerings of Equity Securities in Switzerland by non-Swiss Issuers—Swiss Prospectus Requirements (Cap Law-2009-54), addressing the requirements of Swiss law relating to the documentation of public offerings of shares by non-Swiss issuers in Switzerland, the supporting firms amended it as of 15 June 2010 by adding a suggested disclaimer for non-public offerings of plain vanilla shares of corporate. This suggested disclaimer reads as follows:

Suggested Disclaimer for Non-Public Offerings

The below wording is suggested for plain vanilla shares offerings of corporates (excluding any investment companies, funds, etc).

The Shares may not be publicly offered in Switzerland and will not be listed on the SIX Swiss Exchange ("SIX") or on any other stock exchange or regulated trading facility in Switzerland. This document has been prepared without regard to the disclosure standards for issuance prospectuses under art. 652a or art. 1156 of the Swiss Code of Obligations or the disclosure standards for listing prospectuses under art. 27 ff. of the SIX Listing Rules or the listing rules of any other stock exchange or regulated trading facility in Switzerland. Neither this document nor any other offering or marketing material relating to the Shares or the offering may be publicly distributed or otherwise made publicly available in Switzerland.

Neither this document nor any other offering or marketing material relating to the offering, the Company or the Shares have been or will be filed with or approved by any Swiss regulatory authority. In particular, this document will not be filed with, and the offer of Shares will not be supervised by, the Swiss Financial Market Supervisory Authority FINMA ("FINMA"), and the offer of Shares has not been and will not be authorized under the Swiss Federal Act on Collective Investment Schemes ("CISA"). The investor protection afforded to acquirers of interests in collective investment schemes under the CISA does not extend to a cquirers of Shares.

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Newsflash Securities Trading Summer 2010

Reference: CapLaw-2010-43

By Andrea Huber

Areas of Focus for the Review of 2010 Semi-Annual Financial Statements: In its review of the 2010 semi-annual financial statements of the issuers, SIX Exchange Regulation intends to focus in particular on compliance with the IFRS provisions regarding (i) amended provisions on mergers (IFRS 3R and IAS 27R), (ii) disclosure for the interim period (IAS 34), and (iii) revenue recognition (IAS 18). This list applies mutatis mutandis to the users of US-GAAP (for further details see http://www.six-exchange-regulation.com/admission_manual/09_02_02-SER201002_en.pdf). Regarding the revised enforcement concept of the accounting provisions by SIX Exchange Regulation, please refer to http://www.six-exchange-regulation.com/obligations/financial_reporting/enforcement_concept_en.html.

Shortened Deadline for ETF Listing Applications as of 1 June 2010: Pursuant to Article 4 of the Directive Procedures Equity Securities, listing applications for equity securities must be submitted to the Regulatory Board 20 trading days before first day of listing. To meet the needs of the market and the issuers, SIX Exchange Regulation has shortened the submission deadline for listing applications for exchange traded funds (ETF) to 10 trading days, subject to certain conditions (for further details see http://www.six-exchange-regulation.com/admission_manual/09_02_03-SER201003_en.pdf).

Multi-Currency Trading for ETFs as of 1 June 2010: ETFs and exchange traded structured funds may be traded in several currencies such as CHF, USD, EUR, GBP, JPY and CAD on SIX Swiss Exchange. For products to be newly listed, the trading currencies must be disclosed in the listing application as well as in the listing prospectus. If multi-currency trading is to be introduced for products already listed on SIX Swiss Exchange, a written application must be submitted to SIX Exchange Regulation. In addition, certain enclosures must be provided (for further details see http://www.six-exchange-regulation.com/admission_manual/09_02_04-SER201004_en.pdf).

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Opting-Out is In Again: the Takeover Board Relaxes its Practice on Opting-Out From the Mandatory Bid

Reference: CapLaw-2010-44

Swiss takeover law allows issuers to opt out from the mandatory bid regime. However, the Takeover Board proved reluctant to recognize opting-out clauses, under the doctrine of the prohibition of selective opting-out, which applies to all clauses adopted with a view to benefit a specific acquirer or to apply to a specific transaction. Two recent decisions mark a more relaxed approach to such clauses, refusing to apply this doctrine when the opting-out benefited a specific shareholder and by considering that selective opting-out could be recognized if the interests of shareholders were not prejudiced. This article takes a critical look at the doctrine prohibiting selective opting-outs and these two decisions, and suggesting that while opting-outs are in again and that the doctrine of selective opting-outs should be on its way out.

By Rashid Bahar

1) The Optional Mandatory Bid

Under Swiss takeover law, whoever, directly, indirectly or in concert with other persons, acquires more than a third of the voting rights in a Swiss company listed on a Swiss exchange is obligated to present a mandatory bid to all the holders of equity securities listed on a Swiss exchange (article 33 (1) Stock Exchange Act (SESTA)). This regime seeks to protect minority shareholders from a change of control that would be against their interests. However, instead of relying on voice and courts, this regime focuses on exit rights by ensuring that the minority shareholders will be entitled to sell their shares at a fair price.

The Swiss mandatory bid regime is unique, because of one feature: it is not mandatory! If the issuer decided in its articles of association to opt out from this regime, it will not apply. In other words, if a majority of the shareholders attending the general meeting decides to amend the articles of association to include an opting-out clause, an acquirer who would reach a threshold would not be obligated to give all shareholders the opportunity to tender their shares.

Needless to say, the possibility of an opting-out in a mandatory bid regime implies a contradiction in terms. The mandatory bid is an instrument to protect minority shareholders in the event of a change of control. Yet, through an opting out, the controlling shareholder can take away this protection and let the minority shareholders fend for themselves. This contradiction leads to a regulatory quagmire: if courts and regulators are too lenient with opting-out provisions, the mandatory bid regime will be useless. By contrast, if they are too stringent, the promises of a flexible institutional arrangement on the basis of an opting-out clause will be hollow. Moreover, beyond this trade-off lies a second controversy: who should regulate the right to opt-out of the mandatory bids,

the courts applying general standards of corporate law or the Takeover Board as a specialized administrative commission?

2) The Doctrine of Selective Opting-Out and the End of the Opting-Out Clause:

At first sight, SESTA does not mandate the Takeover Board to police opting-out clauses. Quite to the contrary, it seems instead to consider that introducing such a clause is a corporate law issue, which must be reviewed by the courts under the general principles of corporate law enshrined at article 706 CO. However, in practice, things turned out differently: While courts hardly play a role in this context and, the Takeover Board stepped into the gap: until recently, the Takeover Board and the Federal Banking Commission, the predecessor of the Swiss Financial Market Supervisory Authority FINMA (FINMA), adopted a hostile stance on opting-out clauses. In the leading case on opting out clauses, the Decision of the Federal Banking Commission of 23 June 2000 in re Esec Holding AG/Unaxis Holding AG, the Federal Banking Commission overturned the Takeover Board and considered that an amendment of the articles of incorporation introducing an opting-out in favor of a specific acquirer or in view of a specific transaction was not permissible under Swiss law, even if the decision was approved by a special majority of the minority. The rationale of the decision was that the legal regime called for an all-or-nothing approach: an issuer has the choice between sticking with the default solution and opting out of it once and for all. By contrast, it is not allowed to cherry pick, when the mandatory bid is to apply and when not, as this would potentially deprive the minority shareholders from the regulatory protection when they most needed it.

Soon after, the Takeover Board expanded the scope of this precedent by developing the concept of a substantively selective opting-out: it considered that when an opting-out clause is introduced in the run-up to a change of control, it amounts in essence to a selective opting-out clause and should not be enforceable under takeover law. It, then, went a step further and posited that an opting-out clause introduced during the five year period prior to a change of control is presumed to have been introduced to benefit the acquirer or the contemplated transaction (Recommendation 184/01 Adval Tech AG of 3 March 2004). Therefore, as a practical matter, this line of precedents reduced the possibility of an opting-out to little more than a theoretical possibility in most cases, unless the company had opted out from the mandatory bid prior to a listing.

3) The Revival of the Opting-Out Clause

Two recent cases seem, however, to have adopted a more relaxed approach to opting-out clauses, without formally overturning the precedents on selective opting-outs. While it is too early to conclude that these cases are the sign of a new trend, they

clearly mark a departure from the existing line of precedents and therefore deserve consideration.

a) Decision 437/01 of 4 March 2010 in re CI COM SA

The first case involved the takeover of CI COM SA by Dual Holding SA. CI COM SA was a listed company, which had introduced an opting out clause in 2006. At least since 1997, 60.9% of the voting rights of CI Com were in the hands of Newer SA, a company controlled by Charles Perret, until, in 2009, Newer SA merged with Dual Holding SA, a wholly owned company of Alain Dumenil. By virtue of this merger, the majority shareholder of the Dual Holding SA acquired control over CI COM SA. The main issue was therefore whether this opting-out clause would apply to the transaction which took place less than five years after the introduction of the clause.

First, the Takeover Board considered that the opting-out clause introduced in 2006 was not formally a selective opting-out clause as it did not explicitly cover a specific acquirer or a specific transaction. Then, the Takeover Board went on to determine whether in substance the clause was introduced in view of a specific transaction or a specific person. Considering that Dual Holding SA was incorporated in 2007 and only initiated contacts with Newer in 2009, it held that there was no link between the clause and the transaction with Dual Holding SA or its controlling shareholder Alain Dumenil.

Finally, and more importantly, it considered whether the fact that the opting-out would preponderantly benefit the majority shareholder should impact the validity of the amendment and held that this should not be the case under takeover law. Indeed, the Takeover Board distinguished a materially selective opting-out clause from a clause benefiting a majority shareholder on the basis of the different disclosure levels: shareholders are usually not in a position to identify whether a clause will apply to a specific transaction or specific persons, as this fact will usually not be disclosed. By contrast, the majority shareholder who benefits from the opting out will usually be readily identified (and in the case at hand was clearly identified).

Therefore, in the view of the Takeover Board, whereas, in the first instance, minority shareholders will not be in a position to make an informed decision as to the opting out or to challenge the decision in court, in the second instance, minority shareholders can fend for themselves using the means offered by general corporate law, thus making an intervention of the Takeover Board superfluous. On that basis, the Takeover Board decided that, except in the case of materially selective opting out clauses, it would not review separately the validity of an opting-out clause and defer on this issue to civil courts and concluded that the opting-out clause was valid.

In summary, this case suggests that the Takeover Board focuses exclusively on whether the opting-out clause was explicitly or substantially introduced to benefit a specific acquirer or to apply in a specific transaction. By contrast, all other concerns including the issue whether an opting-out clause benefits primarily a majority shareholder is left to the discretion of civil courts acting in a suit initiated by a minority shareholder under corporate law.

b) Decision 440/01 of 4 June 2010 in re COS Computer Systems AG

In a subsequent matter, regarding COS Computer Systems AG ("COS"), the Takeover Board did not stick to the practice initiated in the CI COM SA. COS was listed company with a relatively dispersed ownership—the largest shareholder held 10.6% of the shares of the company. Since 2007, it was considering its strategic options and divested itself from most of its operational activities. In 2008, its general meeting adopted an amendment to the articles of incorporation introducing an opting-out clause. This amendment, which was approved by 99.74% of the voting rights represented at the meeting, sought to make COS an interesting target for a reverse takeover. A year later, a third party, Johannes Kelders, initiated contacts to acquire COS through a reverse takeover but before going forward solicited a declaratory ruling confirming that it would not be subject to a mandatory bid.

Here again, the issue was whether the clause implied in substance a selective opting-out. The Takeover Board could have taken the easy way and relied exclusively on the *CI COM SA* decision. It could, indeed, have held that the clause was introduced before Johannes Kelders was in the picture and, consequently, before a transaction with him was conceivable. However, it chose another path.

The Takeover Board considered that it was not clear that the opting-out was not materially selective, because the clause was adopted in connection with the strategic review process initiated in 2007, which ultimately led to the change of control in 2010. At the same time, it introduced a new criterion to permit a selective opting-out stating that a selective opting-out could be valid if it does not prejudice the interests of shareholders within the meaning of article 706 CO. Thus, a selective opting-out would be valid if any limitation of the rights of the shareholders is based on valid reasons and any disadvantage incurred by the shareholders is justified by an overwhelming corporate interest (*see* article 706 (2)(2) and (3) CO). In the light of these principles, the Takeover Board considered the specifics of the case and considered that the opting-out was an element of the new strategic orientation and thus was justified by an overwhelming corporate interest. Moreover, it noted that shareholders almost unanimously approved the decision to opt out from the mandatory bid regime and that no shareholder had sought to challenge in court that decision under corporate law. Therefore, the Takeover Board decided that the transaction did not trigger a duty to present a bid.

In sum, this decision marks a new route to validly opt out of the mandatory bid regime: while it nominally maintains the prohibition of selective opting-out decided in the *Essec/Unaxis* case, it offers the acquirer a way out by proving to the Takeover Board that the amendment was valid under corporate law and more specifically does not prejudice the interests of shareholders.

4) The Future of the (Selective) Opting-Out Clause

After the *CI COM* and *COS* decisions, the future of the doctrine of selective opting-out is uncertain. Nominally, neither the *CI COM* nor the *COS* decision departed from existing practice. The *CI COM* decision limits it scope to clauses explicitly or implicitly aiming to benefit a specific shareholder or apply to a specific transaction, whereas the *COS* decision suggests that a selective opting-out can be justified if does not prejudice the interests of shareholders. However, by recognizing this exception, the *COS* decision practically mooted the substantive aspects of the prohibition of selective opting-out. Previous decisions seemed to suggest that if an opting-out was deemed to be selective, the provisions on mandatory bids would apply and the only way to avoid the duty to present a bid was to seek an exemption from the Takeover Board. By holding that a selective opting-out clause is valid if it complies with the general principles of corporate law, the *COS* decision marks a departure from the rationale underlying the prohibition of selective opting-out. The *Esec Holding AG/Unaxis Holding AG* decision of the Federal Banking Commission refused to recognize a selective opting-out in an instance where the decision was probably valid under corporate law and additional safeguards to protect minority shareholders were put in place. Indeed, the *ratio* of the decision was that either shareholders decide as a matter of principle to opt-out from the mandatory bid regime once and for all or they decide to remain in it, in which case the only option open to an acquirer in a specific case is to seek an exemption from this duty in accordance with article 33 (3) SESTA. By permitting an issuer to opt out provided the decision is valid under corporate law the *COS* decision implicitly overturned the substantive rationale of the *Essec/Unaxis* decision.

The *COS* decision, however, stays true to the institutional premise of the *Essec/Unaxis* decision: civil courts will not systematically monitor compliance with the principles of corporate law and will only act if a minority shareholder challenges the decision. By contrast, the Takeover Board will monitor compliance on an ongoing basis and can act by its own initiative, thus ensuring higher level of compliance of the law. The Takeover Board is in a better position than minority shareholders to police opting-out clauses, as it does not face the prospect of a long and complicated civil procedure. In other words, the rationale for this doctrine is that the Takeover Board has an institutional advantage over civil courts.

Nevertheless, this institutional argument forces the Takeover Board to wander out of its realm of competence into corporate law without a legislative mandate. Indeed, the *COS* decision calls on the Takeover Board to weigh in on thorny issues of corporate law, which are best left to civil courts to ponder on as suggested by the wording of article 22 (3) CO SESTA. Moreover, this decision also marks a departure from the *CI COM SA* decision, where the Takeover Board motivated its decision not to expand the definition of a selective opting-out to clauses benefiting a specific shareholder, precisely because corporate law questions were to be decided by courts.

Ultimately, if the Takeover Board is true to its legislative mandate, it should make another step from the *COS* decision and defer to civil courts on the compatibility of an opting-out clause with corporate law. However, making this step would as a matter of fact amount to no less than overturning the *Esec/Unaxis* decision and permitting companies to amend their articles of association to provide for a selective opting out, subject to a challenge by a minority shareholder under the corporate law principles enshrined in article 706 CO.

In conclusion, the *CI COM SA* and the *COS* decisions suggest that the Takeover Board changed its stance on opting-out clauses. After almost prohibiting them *de facto,* both decisions show that an opting-out can be validly included in the articles of incorporation of a Swiss entity and relied upon to avoid the mandatory bid regime. Nevertheless, these decisions conceal two radically different regulatory philosophies: the *CI COM SA* decision enshrines a practice of minimal involvement of the Takeover Board in the realm of corporate law, whereas the *COS* decision instead calls on the Takeover Board to decide itself whether in a specific instance a selective opting-out is valid as a matter of corporate law, without deferring to the courts. These contradictory approaches undermine the value of these precedents: under the *COS* approach, the Takeover Board in *CI COM SA* would have considered whether an opting-out benefiting a specific shareholder did unduly prejudice the interests of the other shareholders, raising the threshold to recognize a valid opting-out. At the same time, if the Takeover Board had deferred to civil courts in *COS* as it did in *CI COM SA,* it would have deferred the entire issue to the jurisdiction of civil courts, thus overturning the core implication of the *Esec/Unaxis.* Overall, while opting-out is again in, perhaps the time has come for the doctrine of selective opting-outs to take the way out.

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The Interim Report of the Expert Commission on the 'Too Big To Fail' Problem: Reading the Tea Leaves

Reference: CapLaw-2010-45

By Roland Truffer / Thomas U. Reutter

On 22 April 2010, the Commission of Experts to Limit the Macro-Economic Risks of Large Enterprises (the "TBTF Commission") formed by the Swiss Federal Council delivered an interim report on its work. While definite recommendations will be published in the Commission's final report expected for early autumn 2010, the interim report shows in which directions the TBTF Commission is thinking.

1) Background

Under the impression of the necessity of state support for UBS that arose in autumn 2008, and against the background of international endeavors to mitigate the problem posed to national economies by enterprises that are *'too big to fail'* (TBTF) and possibly also *'too big to be rescued'* (also called *'Systemically Important Financial Institutions'* or *'SIFIs'*), the Swiss Federal Council in November 2009 formed a ***commission of experts*** to determine how that problem might be addressed. The TBTF Commission comprises scholars, representatives of public authorities (e.g. the Swiss National Bank (SNB), the Swiss Financial Market Supervisory Authority FINMA and the Federal Department of Finance) as well as industry representatives. In its interim report dated 22 April 2010, it presents the course of its inquiries as well as certain preliminary conclusions. The Federal Council already signalled its approval of the contents of the report, and a parliamentary motion lent, further support to its thrust.

2) General

Following an exposition of certain theoretical foundations such as a definition of SIFIs, the economic analysis of their costs and benefits to a national economy and the legal framework for state intervention, the TBTF Commission presents a broad spectrum of possible measures to address the risks posed by SIFIs. These are then discussed, categorized in multiple ways and divided into core measures proposed by the Commission, measures to be further reviewed, and measures which the Commission dismisses.

The interim report concludes that currently, in Switzerland, only the ***two largest banks*** present sufficiently important systemic risks to potentially require the Swiss Confederation to rescue them from insolvency. For various reasons, large insurance companies are not deemed to fall into this category, although their capital market activities and other non-core business are identified as areas where supervision needs to be strengthened.

Among possible ***courses of action*** to address the TBTF problem, measures that reduce an institution's insolvency risk are put opposite measures that facilitate its liqui-

dation, if necessary, mitigate the consequences for the public and ensure that state support is not necessary. In the first category, the TBTF Commission contemplates that reinforced capital and liquidity requirements for SIFIs could increase their resilience and, by progressively reflecting size and other contributory factors to systemic risk, could curb their respective appetite. Amendments of company law are proposed to facilitate the creation of reserve or convertible capital, allowing the bank to increase its equity capital when needed (see below 3)). As for the second category, the Commission contemplates that SIFIs should be required to design their legal and operative structures so that, in the event of insolvency, an orderly resolution and the continuous provision of systemically important services would be possible (see below 4)). Further, reinforced restrictions on risk concentration shall limit contagion effects (but shall, apparently, remain limited to capture of individual counterparty risk and not address generic risk concentrations).

The interim report already contains a draft for certain ***amendments to the Banking Act,*** which would create (or render more explicit) the legal basis for the measures recommended by the TBTF Commission. It also gives a helpful overview of the spectrum of relevant initiatives of international organizations (most importantly, of the Basel Committee on Banking Supervision (Basel Committee) and the Financial Stability Board (FSB)) and in key countries.

3) Capital and Liquidity

a) Special Capital and Liquidity Requirements for SIFIs

The suggestions made in the interim report on the important topics of capital and liquidity appear rather laconic. The TBTF Commission indicates that it will review and assess ***capital adequacy requirements*** depending on the level of systemic risk of a particular financial institution: The higher the systemic risk emanating from a certain financial institution, the higher the capital requirement it must observe.

While this envisaged principle has the benefit of reducing the taxpayer's risk of a potentially massive capital injection, it will also pose a disincentive for the two big banks to grow in their domestic market (given that the indicators for systemic importance would be measured on a national basis), and thus provide a structural protection for less competitive banking institutions in Switzerland. Additional capital requirements for SIFIs would add another cushion to the already stringent capital requirements for major Swiss banks in the international context. Obviously, the outcome of the intended tightening of capital requirements will also depend on how international standards, in particular Basel II and Basel III, will develop. In imposing any stricter than internationally agreed minimum requirements, Switzerland would have to weigh carefully whether the incremental benefit towards the goal of avoiding government intervention for the rescue of a major bank is worth the risk of putting these banks at a disadvantage in the international arena.

The comments in the interim report on ***liquidity*** are even more condensed. The TBTF Commission states that SIFIs must be in a position to continue to operate without external liquidity injection in times of a crisis and hence must comply with tougher requirements on available liquidity. By doing so, it can be assured that there is enough time to adopt rescue measures, and that all options to either maintain a going concern or initiate an orderly liquidation of the respective institution remain preserved. The TBTF Commission does not state whether it considers the new regime of liquidity requirements agreed by the FINMA and the SNB with UBS and CS (published one day before the interim report) sufficient in this respect, nor does it make any specific reference to the ongoing discussions on liquidity on an international level. However, it may be expected that the final outcome of the international framework for liquidity risk measurement, standards and monitoring by the Basel Committee will influence any concrete steps to implement the Commission's recommendations.

b) New Forms of Capital

The interim report proposes two new buckets of back-up capital that can be tapped by the board of directors to issue shares or convertible instruments without the need to convene a shareholder meeting. ***"Reserve Capital"*** *(Vorratskapital)* as a first bucket is modeled along the authorized capital *(genehmigtes Kapital)* well know under Swiss corporate law, but gives the board of directors much wider discretion than its corporate law cousin. ***"Convertible Capital"*** *(Wandlungskapital),* by contrast, is based on the corporate law institution of conditional capital *(bedingtes Kapital)* but again much more liberal than its corporate law equivalent. Convertible Capital, in particular, is aimed at fostering the use of contingent capital instruments along the precedents seen outside of Switzerland (*e.g.* Lloyds or Rabobank). The regulators prefer this type of capital compared to traditional hybrid instruments because debt is usually converted into shares upon occurrence of a pre-determined event of distress. Through a proposed amendment in the Banking Act, these new forms of capital would create a special corporate law regime for banking institutions irrespective of whether they are qualified as SIFIs or not.

Reserve Capital and Convertible Capital need prior shareholder approval, which may be granted with a simple majority of the votes represented. By contrast, their respective corporate law relatives need a two thirds supermajority to be approved. The corporate law institutions "authorized capital" and "conditional capital" are limited to 50% of the issued share capital at the time of approval. No such limitation applies to the new forms of capital proposed in the interim report. The TBTF Commission goes even further and proposes to abolish the two year limitation on the validity of authorized capital for the new form of Reserve Capital. In addition, the interim report suggests that the board of directors has full discretion to exclude the pre-emptive rights of existing shareholders, if any of these new forms of capital is drawn and shares or convertible instruments are

issued. Finally, the TBTF Commission alludes to a possible safe harbor from director's liability to be introduced in connection with measures to strengthen the capital base.

Obviously, the overarching aim of the new forms of capital is to facilitate the strengthening of the capital base of financial institutions in times of crisis: The lengthy, cumbersome and risky process of calling an extraordinary general meeting with uncertain result should be avoided. As a consequence, financial institutions should be more resilient in a crisis and government intervention should be less likely. In the eyes of the TBTF Commission, these goals apparently justify the sacrifice of shareholder rights enshrined in corporate law and the ***transfer of powers*** to the board of directors. Of course, however, it is not the shareholders, but the board of directors who is entrusted with the ultimate conduct of business and this body will always adopt measures that are likely to remedy any misjudgment previously made. There is a certain danger, therefore, that the board of directors follows its own agenda in a time of crisis and the shareholders will not be able to do much about it, should the above proposal be adopted.

4) Organization and Resolution

a) Organization and Contingency Planning

The TBTF Commission notes that in the event of a crisis, it is important that the reconstruction or insolvent liquidation of a SIFI can generally occur in an orderly and controlled manner, and that the ***continuous performance of systemically relevant functions*** (from the viewpoint of the Swiss national economy) can be ensured despite the insolvency proceedings. Only if this is ensured, the government can afford to let a SIFI enter insolvency, which in turn gives credibility to the threat of insolvency and permits it to deploy a preventive effect. A SIFI's 'resolvability' is influenced by matters such as its legal structure, its internal dependences (*e.g.* for capital, liquidity, credit, staff and infrastructure, both within and between legal entities), and the level of advance planning for resolution.

Possible ***specific measures*** in this respect which are mentioned in the report include the segregation, in a separate legal entity, of systemically important functions (*e.g.* payment administration, domestic lending and deposit-taking) and/or of central service functions on which they depend; the reduction of such dependence of business units on centrally administered services; the reduction of geographical asymmetries of assets and liabilities; and the timely establishment of *'Recovery and Resolution Plans'.* The TBTF Commission apparently does not favor the enactment of general legal requirements in this respect. Rather, each SIFI should itself be responsible to order its affairs so that the continuity of its systemically relevant functions would be ensured in the event of insolvency, and to continuously and intensively plan and prepare for such a situation. The FINMA would supervise this process, and only intervene with specific directions for the institution's organization and internal structure if the institution's own endeavors in this respect appear insufficient.

b) Insolvency Law

Once a SIFI is insolvent, applicable insolvency laws will determine (together with the institution's structure and preparedness, see above) to what extent the continuity of systemically relevant services may be ensured. The TBTF Commission refers to the Federal Council's proposals to revise the provisions of the Banking Act on the reconstruction and insolvent liquidation of banks, which were published shortly after the interim report (BBl 2010 3993). These proposals include extended powers for the FINMA, as part of a reconstruction proceeding, to transfer systemically important parts of a bank to another institution or to a special-purpose entity *('bridge bank')*. The TBTF Commission reserves judgment on the question whether these amendments will need to be complemented by specific rules for SIFIs, and notes that the international harmonization of insolvency rules for globally active financial groups remains a long-term goal. It also mentions the possibility to further extend the powers of supervisory authorities in the event of a crisis, including powers to coordinate measures internationally (where the existing *'supervisory colleges'* will in the event become *'crisis management colleges'*).

5) Conclusion

The TBTF Commission's thinking and proposals are generally in line with international initiatives in the field. Measures such as those contemplated in the interim report can make a contribution to the overall goal of reducing the risk that state support to rescue a SIFI becomes necessary. At least some of them, however, also have their drawbacks (apart from financial costs), for example in respect of the balance of powers between a bank's shareholders and its directors. International coordination remains important; while the TBTF Commission is expected to publish its final report as early as August or September 2010 and therefore will not be able to take account of the results of international workstreams expected for the autumn of 2010 (*e.g.,* the final recommendations of the FSB on SIFIs to be submitted to the G20 November Summit), it is to be hoped that such results will be considered at the stage of implementing the Commission's recommmendations.

The chances of success in making state interventions in favor of SIFIs obsolete remain difficult to estimate. Although it is worthwhile to tackle this problem from all relevant sides, it should be remembered that the concern for the continuous provision of systemically important services to the national economy is not the only reason why politicians are tempted to save distressed financial institutions. They may still do so simply to save jobs, depositors' money, or the country's reputation.

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New Proposed Rules on the Compensation of Insurance Brokers Under the Draft Insurance Contract Act

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By Dominique Mueller / Melissa Gautschi

The Insurance Contract Act of 2 April 1908 (ICA) is currently being fully reviewed with a view to bringing it up-to-date, especially with developments in the insurance industry and the relevant legislation in the neighboring countries and the rest of Europe. This article focuses on the proposed rules governing the compensation (commission) of insurance brokers. It first describes the compensation practices under the current law and then discusses the new suggested statutory rules, also taking into account the principal opinions and solutions that have been put forward in this respect.

1) The Compensation of Insurance Brokers Under the Current Law

a) Definition of Insurance Broker

In contrast to an insurance agent, an insurance broker from a civil law point of view *(Versicherungsmakler)* is an intermediary, who represents the interests of the policyholder, and essentially performs the following services:

- assessment of the risk situation and the need for insurance cover,
- comparison of offers,
- preparation of the submission documentation,
- placement of insurance policies,
- supervision and management of the insurance portfolio,
- handling of claims, etc.

b) No Regulation of Brokers' Compensation

There are currently no statutory rules under Swiss law specifically governing the compensation of insurance brokers, and the regulator in charge of the supervision of insurance intermediaries, the Swiss Financial Market Supervisory Authority FINMA (FINMA), has not either issued any guidelines in this respect. The Swiss Insurance Brokers Association (SIBA) has however produced best practice rules for its members that contain compulsory provisions regarding compensation.

c) Current Compensation Practice

As a rule, in addition to their (oral or written) agreements with the policyholders, brokers have cooperation agreements with insurers regarding the placement of their pol-

icies and the resulting compensation (for services provided both to the insurers and to the policyholders). ***Usually, therefore, brokers receive their remuneration from the insurers and not from their actual clients (policyholders).*** Of course, there are cases where the policyholder and the broker agree on compensation by the former *(Honorarberatung),* but this remains an exception.

However, as (part of) the insurance premium owed by the policyholder serves to finance the payment for brokerage services made by the insurer, ***it is the policyholder who ultimately bears these costs and therefore indirectly remunerates the broker.***

The broker's compensation generally amounts to a percentage of the insurance premium, deposit or sum insured, which is mainly paid not only upon the insurance policy being taken out, but continuously for the duration of the insurance contract. This basic compensation constitutes remuneration for the placement of the insurance policy, but also for other services provided to the policyholder, such as risk management, claims' handling, etc. As a result, policyholders benefit from the services of brokers without having to compensate them on a time spent basis.

It has furthermore long been (and in certain cases still is) customary in the insurance industry to pay the brokers overriding commissions or contingent commissions. These are supplementary payments subject to the achievement of additional objectives, such as the increase of sales volume, improvement of the profit ratio or loss ratio, etc. Under the aforementioned SIBA rules, affiliated brokers are precluded from receiving contingent commissions.

d) Conflict of Interest

The current compensation practice, in particular the payment of overriding commissions and/or contingent commissions, can give rise to serious conflicts of interest, as it creates an incentive for brokers to favor the products of those insurers, whose compensation schemes are more advantageous to them. Needless to say, policies chosen based on this criterion do not always constitute the best insurance solution for the policyholders.

In its judgment of 22 March 2006 regarding kick-backs *(Retrozessionen)* and finder's fees, the Swiss Federal Supreme Court examined whether asset managers have a duty towards their principals to deliver any kick-backs and similar fees received from a third party, and under which circumstances the principal can validly waive the delivery of such earnings (BGE 132 III 460). Even though the judgment relates to asset managers and cannot be fully transposed to the relationship between insurance brokers and their clients (policyholders)—as, contrary to the insurance brokers (at least with respect to the basic compensation, which does not always include an element of remuneration

for services rendered to the insurer), the independent asset managers receive the kick-backs in addition to their compensation for services rendered to the principal–, ***the rationale for the decision, especially as regards the duty of transparency, could nevertheless be applied to insurance brokers.***

The Federal Supreme Court's main conclusions were as follows:

– Based on the applicable rules of mandate, the asset manager is in principle held to deliver all that he/she receives from a third party in the course of and in direct connection with the performance of the services.

– The principal can expressly waive the delivery of fee earnings (*e.g.* kick-backs, finder's fee, etc.) if he/she has been ***exhaustively and truthfully*** informed about the expected fees.

– An implicit waiver can only be presumed to have been exercised if the principal was aware of the amount of fees agreed with third parties as well as of the probable frequency of the fee payments.

In its decision of 26 June 2007, the Commercial Court of Zurich construed the expression *"exhaustively and truthfully"* as an information that would provide the client some indication as to the expected amount of kick-backs, respectively enable the client to at least assess said amount.

2) Proposed Statutory Regulation of the Compensation of Insurance Brokers

As previously mentioned, the ICA is currently undergoing a full revision. The consultation process *(Vernehmlassungsverfahren)* ended on 31 July 2009 and the Swiss Federal Council's Consultation Report was published in January 2010. As to the Dispatch *(Botschaft),* it is expected to be issued in the fall of 2010, as the Federal Council has chosen to first clarify some of the suggestions put forward in the consultation process.

In the course of this revision, statutory rules on the compensation of insurance brokers have been introduced in ***article 68 of the draft ICA,*** which provide for the following:

– Insurance brokers shall receive the compensation for their services ***directly from the policyholders.*** This provision is mandatory and can therefore not be altered (paragraph 1).

– Insurance brokers are under the obligation to ***deliver to the policyholders any payments received from the insurers,*** such as commissions *(Provisionen),* overriding commissions *(Superprovisionen)* or any other monetary values ***that are directly or indirectly connected to the insurance contract*** (paragraph 2).

– Policyholders may only waive the delivery of such payments in writing and ***by offsetting them against the compensation according to paragraph 1*** (paragraph 3).

It is unclear, however, whether the brokers may retain any surplus (in case the compensation paid by the insurer is higher than the compensation owed by the policyholder) or whether such surplus would also need to be delivered to the policyholder. According to the Explanatory Report on the Consultation Template *(Erläuternder Bericht zur Vernehmlassungsvorlage),* the surplus shall remain with the insurance brokers, yet this interpretation is in contradiction with the wording and meaning of the draft ICA. It is expected that the Federal Council's Dispatch will shed light on the exact meaning of this provision with respect to surpluses.

In order for these amendments to also be reflected on a supervision law level, it is furthermore proposed to ***extend the current duty of information of the broker set out in article 45 of the Insurance Supervision Act (ISA)*** so as to encompass a duty to inform the policyholder on (i) the obligation to deliver any payments received from the insurer, (ii) the type, amount and calculation of any such payment and (iii) the conditions under which the policyholder may validly waive the delivery of such payments (article 45 (1bis) and (1ter) of the draft ISA).

3) Appraisal of the New Proposed Regulation

The draft proposal for the new statutory regulation of the brokers' compensation has given rise to serious discussions, not only in the brokerage industry but in the insurance industry as a whole.

In essence, the brokerage industry suggested the deletion of article 68 of the draft ICA and the expansion of the duties of information under article 45 of the draft ISA (enhanced transparency with respect to third party payments) as well as the implementation in the ISA of a new provision precluding brokers from accepting contingent commissions. As to the insurance industry, it suggested—via the Swiss Insurance Association—deletion in the first instance and, alternatively, amendment of article 68 of the draft ICA. These opinions are reflected in the Consultation Report.

On the whole, the suggested regulation calls for a rethink in the Swiss brokerage business, not only from the brokers' but also from the policyholders' point of view. One needs to keep in mind that policyholders currently remunerate the brokers indirectly with part of their insurance premium and that the brokers' services are not restricted to the placement of the policy, but also include a range of other services, such as handling of claims, requirements analysis, etc., for which the policyholder does not have to pay additional fees. Consequently, ***it is uncertain whether the policyholders would fare better if they had to remunerate the brokers separately for every service***

rendered (as a result of the new obligation for brokers to receive their compensation directly from the policyholders).

What is of more importance is that under the new proposed rules, policyholders would neither be free to choose whether to compensate the brokers directly or indirectly (*i.e.* via the insurer) ***nor would they be allowed to fully waive the delivery of payments received by the brokers from the insurers.*** Such a rule would overshoot the mark and constitute a serious and unnecessary restriction of the freedom of contract. It would go beyond the requirements of the aforementioned jurisprudence, according to which a waiver of the delivery of compensation paid to the intermediaries by third parties is possible, subject to adequate commission disclosure, *i.e.* as long as the client possesses some indication as to the expected amount of compensation, respectively can at least assess said amount.

On the other hand, given the brokers' "dual role" (representing on the one hand the interests of the policyholders and acting on the other hand as distributors for the insurers) and the ensuing potential for conflicts of interest, ***there is a clear need for increased transparency with respect to their compensation.***

As the rules of mandate already provide for the broker's general duties of information and delivery, this issue could be addressed without interfering in the parties' freedom of contract by simply amending the existing article 45 ISA so as to include the duty of the broker to actively inform the policyholder about the amount or mode of calculation of any compensation (basic compensation, overriding commission or other remuneration) received or expected to be received from the insurer, which is directly in connection with the concerned insurance policy, as well as the portion of the compensation that constitutes remuneration for services rendered to the insurer. The advantage of this approach would be to increase transparency on payments received by the broker, hence also provide the basis for a valid waiver of the delivery of fee earnings in accordance with the jurisprudence of the Federal Supreme Court, whilst continuing to allow for an indirect remuneration via the insurance premium (including for services beyond the mere placement of policies). Furthermore, all specific information duties of the insurance brokers would be dealt with in a single statutory provision, albeit on a regulatory rather than on a civil law level.

We shall closely follow the legislation process and await with interest the Dispatch of the Federal Council which will reveal to which extent the numerous consultation inputs have influenced the final regulation of the compensation of insurance brokers.

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Update on Over-The-Counter (OTC) Derivatives Legislation

Reference: CapLaw-2010-47

The financial crisis has brought the derivatives to the forefront of regulatory attention. In the last issue (CapLaw-2010-34), we gave an overview on the pending initiatives to regulate OTC derivatives in the U.S. and in the EU. Since then, some significant developments have occurred. This article provides an update on the pending initiatives to regulate OTC derivatives in the U.S. and in the EU.

By Thomas Werlen / Stefan Sulzer

1) United States

On 12 December 2009, the House of Representatives passed the H.R. 4173, *the Wall Street Reform and Consumer Protection Act of 2009* (the House Bill) (available at http://financialservices.house.gov/Key_Issues/Financial_Regulatory_Reform/FinancialRegulatoryReform/hr4173eh.pdf). The House Bill attempts to increase transparency, availability and reliability of information in the OTC derivatives markets by providing for the registration, supervision and regulation of swaps and swap market participants.

On 20 May 2010, the Senate also passed legislation, *the Restoring American Financial Stability Act of 2010* (the Senate Bill) (available at http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:h4173pp.txt.pdf). The Senate Bill is based primarily upon the legislation crafted by Senator Chris Dodd in the Senate Banking Commission. The derivatives portion of the Senate Bill, however, incorporates the compromise language agreed to by Senators Chris Dodd and Blanche Lincoln, based in large part on the work of the Senate Agriculture Committee.

The House Bill and the Senate Bill were then moved to a conference committee to be reconciled and combined. On 25 June 2010, the joint House and Senate committee agreed on final details and then sent the agreed bill to both houses for approval. The House of Representatives passed it on 30 June 2010, whereas the Senate has not voted yet. The bill is not expected to be signed into law by President Obama until the mid-July.

2) European Union

In October 2009, the European Commission announced that it will come forward with comprehensive proposals to regulate the OTC derivatives markets.

On 11 February 2010, European Parliament member Werner Langen published a draft report on the OTC derivatives reforms to be considered by the European Parliament's Economic and Monetary Affairs Committee (ECON) in its decision on how the Euro-

pean derivatives markets should be regulated going forward. The Langen Report supports the European Commission's aims to reduce default risk, to reduce operational risk, to increase transparency and to enhance market integrity and oversight. In addition, the Report outlines several matters to which particular attention should be paid, including:

(a) The prices of derivatives should better reflect risk. The cost of the future market infrastructure must be borne by only market participants and not by taxpayers;

(b) Central counterparties and their risk management systems must not be financed by users or by competitors;

(c) Reporting standards must be laid out for all derivatives so as to ensure that they are communicated to central trade repositories;

(d) Credit default swaps (CDS) must be subject to independent central clearing; and if necessary, where cumulative risks are involved, it must be possible to restrict them, or, on a case-by-case basis, prohibit them;

(e) National regulatory authorities must be given access to trade repositories; and

(f) Responsibility to authorize Central Counterparties (CCPs) in the European Union and third states should be given to the European Securities and Markets Authority (ESMA).

On 2 June 2010, ECON adopted a resolution setting out its recommendations for a new EU-wide regulation of OTC derivatives (available at http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//NONSGML+REPORT+A7-2010-0187+0+DOC+PDF+V0//EN). It thereby followed the recommendations of the Langen Report to a great extent. ECON is clear on the need for the legislation on derivatives to be tailored, depending on the type of derivative involved and the parties involved in the transaction. Individually negotiated derivatives, for example, are singled out as being necessary to hedge special risks and therefore should not form part of any sort of standardization of derivatives. Similarly, non-financial small and medium-sized enterprises, which use derivative instruments solely in the course of hedging their risk when conducting their principle business, should benefit from exemptions from clearing and collateralization related capital requirements, provided that the transactions are proportionate and appropriate for the real risks faced by end users.

On 15 June 2010, the European Parliament adopted the Langen Report and supported ECON's recommendations. The European Parliament also welcomed the European Commission's intention to submit legislative proposals on clearing houses and trade repositories as early as mid-2010. Given the fact that the European Com-

mission will ultimately need the support of the European Parliament if its proposals are to be enacted, the European Parliament sent a strong message to the European Commission of what it is expecting to see.

We will continue to monitor and report on these proposals as the legislation evolves.

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Mobimo Holding AG closes CHF 175 million 2.125% Convertible Bond Issue due 2014

Reference: CapLaw-2010-48

Mobimo Holding AG (the Issuer), whose shares are listed on SIX Swiss Exchange, successfully raised financing through a placement of CHF 175 million Convertible Bonds due 2014 (the Bonds), convertible into shares of the Issuer. The Bonds were priced with a coupon of 2.125% and a conversion premium of 13% to the volume weighted average price of the shares on the day of launch. Application has been made for provisional admission to trading of the convertible bond on the SIX Swiss Exchange as from 25 June 2010, payment date was 30 June 2010. UBS Investment Bank acted as lead manager and sole bookrunner on this transaction and Bank Vontobel AG, Zürcher Kantonalbank and Reichmuth & Co acted as co-managers.

Orior AG successfully completes Initial Public Offering

Reference: CapLaw-2010-49

In Switzerland's first initial public offering (IPO) since May 2008, Orior AG (Orior or the Company) was listed on the SIX Swiss Exchange on 22 April 2010. On 5 May 2010 the Company was informed that the Over-Allotment Option has been exercised in full. In the IPO, 1,675,000 newly issued shares and 2,263,750 secondary shares (including the Over-Allotment Option) held by the existing shareholder Capvis were offered to investors. Based on the offer price of CHF 48, the Company was valued approximately CHF 284 million on the first day of trading. A banking syndicate led by Credit Suisse AG as Global Coordinator and Bookrunner and Bank Vontobel AG and Zürcher Kantonalbank as Co-Lead Managers assisted in this transaction.

Quo Vadis—Swiss Financial Center? System and Banks—Who is Big Enough?
(Quo Vadis – Finanzplatz Schweiz? System und Banken – Who is Big Enough?)

Thursday, 26 August 2010, 08.30-17:15 h, University of Zurich

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