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Covered Bonds

Reference: CapLaw-2012-50

While traditional (statutory) *Pfandbriefe* still dominate the Swiss covered bond market, the avenue of structured (contractual) covered bonds has recently been explored when first UBS (in 2009) and then Credit Suisse (in 2010) established their respective covered bond programs and presents an alternative for Swiss mortgage lenders seeking for flexibility and an improved access to international institutional investors. This article describes the key features of Swiss structured covered bonds.

By Dieter Grünblatt / Stefan Kramer / Benedikt Maurenbrecher

1) Introduction

According to the European Covered Bond Council's definition, covered bonds are secured debt instruments which satisfy the following criteria: (i) The issuer or the guarantor of the debt instrument is a prudentially regulated credit institute (*i.e.*, a bank); (ii) the debt instruments are secured by a cover pool of mortgage loans (property as collateral) or public-sector debt to which investors have a preferential claim in the event of default; and (iii) the bank has a continuing obligation to provide a sufficient amount of assets to the cover pool in order to be able to satisfy the claims of the covered bond investors, and compliance with such obligation is subject to supervision by a public authority or independent third party.

In Switzerland, there are two different legal concepts which correspond to this definition.

On the one hand, in 1931, the Swiss legislator created the Swiss *Pfandbrief* system by enacting the Mortgage Bond Act (MBA), complemented by a respective ordinance (Mortgage Bond Ordinance, or MBO). The MBA provides for explicit regulations regarding all key elements of the *Pfandbrief* system, such as the institutions authorised to issue instruments under the MBA, the structure and valuation of the cover pool, and certain insolvency-related issues.

On the other hand, the concept of freedom of contract allows an issuer to structure a covered bond program based on contractual agreements with investors and other persons or institutions to be involved in the transactions. Instruments issued under such contractual agreements qualify as structured covered bonds. The avenue of structured covered bonds has only recently been explored in Switzerland, when first UBS (in 2009) and then Credit Suisse (in 2010) established their respective covered bond programs.

Today, *Pfandbriefe* still dominate the Swiss (covered) bond market with an aggregate size of CHF 63,7 billion or 24,5% (end of 2011) of the nominal amount outstanding of all listed domestic bonds. The issuing volume for Swiss *Pfandbriefe* is somewhat restricted, however, since the capital adequacy provisions in the MBA provide that, in addition to the maintenance of the cover pool, Swiss *Pfandbriefe* must be underpinned by equity of PBB and PBZ in excess of 2% of their respective total *Pfandbrief* issuance volume. Nevertheless, *Pfandbriefe* are the second-largest and second-most liquid segment of the Swiss franc bond market after Swiss government bonds *(Eidgenossen).* Structured covered bonds are catching up quickly in light of the Swiss big banks having more than CHF 13 billion outstanding at the end of 2011, mainly in the form of jumbo issuances into the European market.

2) Swiss Structured Covered Bonds

a) Key Elements

Due to the aforementioned limitations applicable to the Swiss *Pfandbrief* market, and in response to the tightening of the market for liquidity during the financial crisis, the two Swiss big banks developed structured covered bond programs which fall outside the scope of the MBA. The contractual structure of these programs allowed UBS and Credit Suisse to include a number of structuring features which aim to improve investor protection and enabled the covered bonds to be allocated an AAA/Aaa rating.

Under Swiss covered bond issuance programs, covered bonds are issued into the international market by the UK or other non-Swiss branch of a Swiss bank as issuer. Initially, issuances were predominantly made in reliance on Regulation S under the US Securities Act of 1933 into the European market. More recently, both issuers followed up with 144A offerings into the United States.

There are a number of key elements of this structure:

1. The Swiss bank, acting through a non-Swiss branch, issues covered bonds as direct, unconditional and unsubordinated obligations of the issuer.

2. The obligations of the issuer under the covered bonds benefit from a guarantee issued by a subsidiary of the issuer under a so-called guarantee mandate agreement in favour of the holders of covered bonds, represented by the bond trustee.

3. Under the guarantee mandate agreement, all liabilities, costs and expenses incurred by the guarantor under or in connection with the guarantee will have to be reimbursed (or pre-funded accordingly), by the issuer.

4. As security for the relevant reimbursement and pre-funding claims of the guarantor, the Swiss bank transfers a pool of mortgage loans, together with the related mortgage security, to the guarantor.

Accordingly, if the issuer defaulted under the covered bonds and the guarantee was to be drawn, the guarantor could claim for coverage by the issuer under the guarantee mandate agreement. Failure by issuer to pre-fund the payments lowered under the guarantee would allow the guarantor to enforce in the cover pool (as further described below) and to use the proceeds to satisfy its payment obligations under the guarantee.

To a considerable extent, Swiss structured covered bonds build on features developed in the context of English structured covered bonds. But the resulting structure is unique, driven by Swiss legal, regulatory, tax and insolvency law considerations. Furthermore, combining the requirements of issuing into the international market with the particularities of a cover pool consisting of Swiss mortgage assets has led to a bifurcation of the governing law:

Certain agreements essential for the functioning of the covered bond program, such as the intercreditor deed governing the priority of payments in relation to the proceeds of the cover pool and the guarantee deed pursuant to which the guarantor guarantees the payment of principal and interest under the covered bonds, are governed by English law. English law also applies to the swap agreements needed for purposes of mitigating the interest rate risk and the currency risk and certain other documents (cash management agreement, trust deed, agency agreement, and so on).

Conversely, the agreements governing the establishment of the cover pool and the relationship between the issuer and the guarantor are governed by Swiss law. Relevant agreements include the agreement under which the mortgage loans and the related mortgage certificates are transferred to the guarantor and into the cover pool. The same applies for the guarantee mandate agreement pursuant to which the issuer instructs the guarantor to issue a guarantee for the payment obligations of the issuer under the covered bonds.

b) Role of Issuer

Following the issuance, the main duty of the issuer in relation to the covered bonds is to always maintain an appropriate level of eligible mortgage assets or substitute assets in the cover pool. The cover pool assets are legally owned and held by the guarantor rather than by the issuer. The mortgages are, however, only transferred to the guarantor for security purposes and therefore remain on the issuer's balance sheet (as further explained below).

c) Guarantor and Guarantee

The guarantor is a Swiss corporation, which is majority-owned by the relevant issuer with two independent board members which are also minority shareholders. Under the constitutional document of the guarantor, the two independent board members/shareholders are granted a veto right in respect of all relevant decisions on the shareholders and the board level. This corporate governance setup is designed to enhance the protection of the interests of the covered bond investors and the stability of the guarantor in case of an insolvency of the issuer.

The guarantor is structured as a bankruptcy remote special purpose vehicle with a limited corporate purpose. In essence, this purpose consists in holding and, if necessary, enforcing the assets in the cover pool. Therefore, the guarantor may only enter into such agreements and transactions as are necessary to effectively perform its function under the covered bond program. Moreover, it benefits from non-petition and limited recourse provisions, to which substantially all parties to the transactions have acceded with view to reinforce the bankruptcy remoteness of the guarantor.

While an issuer event of default accelerates the payment obligations of the issuer, it will not change the payment schedule under the guarantee. Accordingly, amounts of principal and interest will be payable by the guarantor as originally stipulated in the terms of the bonds as long as no guarantor event of default occurs. Such event would occur if a guarantor failed to make any payments when originally due, an amortisation test failed or if the guarantor itself became insolvent.

As indicated, the guarantee is issued pursuant to a Swiss law guarantee mandate agreement entered into between the issuer and the guarantor. Under this agreement, the issuer instructs the guarantor to issue a guarantee for the benefit of the holders of covered bonds, on the account and risk of the issuer. As consideration for the issuance of the guarantee by the guarantor, the issuer pays to the guarantor an annual guarantee fee. As mentioned earlier, the issuer also undertakes to indemnify and pre-fund the guarantor for any outstanding and future amounts payable by the guarantor under or in connection with the guarantee and to reimburse any such payments made by the guarantor which have not been pre-funded.

For Swiss regulatory and tax reasons, the mortgage claims in the cover pool only secure the indemnification and pre-funding obligations of the issuer towards the guarantor under the guarantee mandate agreement, but not the claims of the holders of covered bonds under the guarantee. Technically speaking, the obligations of the issuer under the covered bonds are, therefore, (aside from the guarantee) unsecured obligations of the issuer. Moreover, as opposed to English covered bonds, the issuer does not sell the mortgages in the cover pool. Rather, for Swiss insolvency law and other reasons they are only transferred to the guarantor for security purposes.

d) The Cover Pool

The cover pool consists of residential mortgage loans which are transferred for a security purpose to the guarantor together with the related mortgage certificates. Accordingly, the guarantor will acquire legal title in the mortgage certificates, which represent the lien on the residential real estate encumbered. In addition, certain substitutes such as cash or governed bonds may form part of the cover pool.

Each mortgage certificate transferred will continue to secure only the related mortgage loan(s) and can not be enforced unless a relevant mortgage loan is in default. Together with a number of other precautions, this helps to ensure that the interests of the mortgage debtors are not unfairly prejudiced by virtue of the transaction.

The mortgage loans in the cover pool have to meet certain eligibility criteria including a certain maximum loan-to-value ratio (LTV). Moreover, the composition of the cover pool has to meet certain additional criteria, including a minimum amount of over-collateralisation acceptable to the rating agencies from time to time. Accordingly, the mortgages in the cover pool are subject to regular replenishment and substitution in order to ensure ongoing compliance with the relevant tests and eligibility criteria.

In case of insolvency of the issuer, the bondholders benefit, in addition to their direct recourse to the issuer, from the guarantee issued by the guarantor, which is backed by the assets in the cover pool. While mortgages in the cover pool have been transferred to the guarantor for security purposes only and, therefore, have remained on the balance sheet of the issuer, in an insolvency of the issuer, the assets in the cover pool would be segregated from the estate of the issuer. Accordingly, as the guarantor is the title owner of the cover pool assets it may, subject to any avoidance action, manage and enforce such assets independently from any insolvency procedure concerning the issuer. Upon the occurrence of an enforcement event, the guarantor is entitled to liquidate a sufficient part of the cover pool assets to by collecting the mortgage claims (if and when they fall due) or, subject to certain restrictions, by way of a private sale of mortgage assets to an eligible investor.

3) Conclusion

Recent developments have not only highlighted the importance and versatility of the Swiss *Pfandbrief*, but have also increased the options available to Swiss mortgage institutions. The development of a transaction structure compatible with the Swiss legal environment, the prevailing practice in the Swiss mortgage business and the requirements of issuances into international markets offers Swiss mortgage lenders flexibility and an improved access to international institutional investors.

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FINMA Orders in Court

Reference: CapLaw-2012-51

The legislator gave FINMA powerful tools to enforce its interpretation of the financial market acts against regulated companies and individuals. Practitioners noticed that FINMA has been intensifying the use of such tools recently. At the same time FINMA's willingness to settle disputes diminished. This article discusses from a practitioner's viewpoint the rules FINMA has to follow during enforcement procedures and the appeal stages available to entities and individuals confronted with an adverse order by FINMA.

By Andreas Rüd

1) The Enforcement Process

If the Swiss Financial Market Supervisory Authority FINMA (FINMA), after preliminary investigations, reaches the conclusion that the financial market acts may have been violated it will communicate the opening of administrative proceedings to the affected parties (article 30 of the Financial Market Supervisory Authority Act (FINMASA)). In cases which already had press coverage or which are considered to be of public interest FINMA will also publicly announce the opening of administrative proceedings. Such announcement can already have a severe impact on the reputation of the involved parties.

The administrative proceedings itself are governed by the Swiss Federal Act on Administrative Proceedings (SFAAP) (article 53 FINMASA). The SFAAP grants to the parties some basic procedural rights *e.g.* the right to be heard (article 29 SFAAP), the right of access to records (article 26 SFAAP), the right to attend witness hearings and to ask supplementary questions (article 18 SFAAP) and the right to an impartial composition of the deciding body (article 10 SFAAP).

FINMA does not always respect party rights during administrative proceedings. Often the intervention of counsel is necessary to remind FINMA of its duties. Counsel should also pay special attention to the facts relevant to the case by making motions for admission of additional evidence where appropriate.

If the administrative proceedings involve both, a company and members of its management, it is important due to possible conflicts of interest and as well for tactical reasons that the parties retain individual counsel. Counsel must be able and willing to closely work together. Mutual recriminations should be avoided at all cost and a common strategy should be defined at the outset of the administrative proceedings.

The affected parties are usually well advised if they rectify obvious deficiencies within their organization during the administrative proceedings as this will improve their chances of a favorable outcome, *e.g.* FINMA may deem a declarative order sufficient if measures have already been taken to ensure that no future violations of supervisory provisions will occur.

The parties have a statutory duty to assist FINMA in its investigations (article 29 FINMASA and article 13 (1) (c) SFAAP). According to FINMA's interpretation the duty to assist also applies to individuals resulting in a possible conflict with the provisions against self-incrimination. The question has not yet been decided by the Courts.

2) The Order

Following a practice of its predecessor SBC FINMA circulates in less severe cases a draft of its intended order among the parties. This is sometimes done to offer affected individuals a face-saving way out by resigning from their positions. In cases where more severe measures like confiscation (article 35 FINMASA) or a professional ban (article 33 FINMASA) are considered a resignation will not end the administrative procedure and, thus, no draft order will be circulated.

FINMA has the power to declare its order partially or in full as immediately enforceable. This can entail severe consequences since precedents can be created which cannot be altered even when an appeal is successful, *e.g.* if members of the management are removed from office or a liquidation of a company is ordered by FINMA. An abstract of the order will be published if FINMA has publicly announced the opening of administrative proceedings or, if severe violations of the regulatory laws have been found (article 34 (1) FINMASA).

3) The Appellate Process

An appeal against an order by FINMA can be filed within 30 days after receipt with the Federal Administrative Court (article 50 SFAAP; article 33 of the Swiss Federal Administrative Court Act (FACA)). The appeal will suspend FINMA's order (article 55 (1) SFAAP) unless declared immediately enforceable by FINMA. The Federal Administrative Court has the authority to revoke an immediate enforceability (article 55 (3) SFAAP) however it rarely does so. Especially in complex cases the statutory period of 30 days, which is non-extendable, is very short and parties considering an appeal in case of an unfavorable outcome of the administrative proceedings are well advised to instruct their counsel to timely commence the work on the appellate brief.

The Federal Administrative Court has the power to fully review the facts and the legal issues of the case including FINMA's administrative discretion (article 49 SFAAP). However, the Federal Administrative Court follows the practice not to second-guess FINMA's discretionary decisions as FINMA is considered an agency with specialized know-how.

After receipt of the appellate brief and after payment of a deposit for court fees the Federal Administrative Court will invite FINMA to file an answer to the appellate brief. Contrary to other government agencies FINMA takes an active role in the procedure and defends its orders vigorously. Additional exchanges of briefs can be ordered by the Federal Administrative Court (article 57 (2) SFAAP). The procedure before the Federal Administrative Court usually takes approximately 6 to 12 months depending on the complexity of the case and the number of briefs exchanged.

In its judgment the Federal Administrative Court can remand, affirm or change FINMA's order. The judgment is subject to appeal to the Federal Supreme Court within 30 days (article 100 (1) of the Swiss Federal Supreme Court Act (FSCA)). An appeal to the Federal Supreme Court will only suspend the judgment if this is especially ordered by the Federal Supreme Court (article 103 (1) and (3) FSCA). The Federal Supreme Court's power of review is limited to legal issues. The facts are not revisited unless they seem arbitrary (article 105 (1) FSCA).

4) Conclusions

When it comes to an enforcement process supervised entities and individuals are not entirely but to a large extent at the mercy of FINMA. The remedies available to the parties are of limited use since they cannot cure the negative impact of public announcements by FINMA. FINMA's power to declare its orders immediately enforceable combined with the Federal Administrative Court's reluctance to revoke immediate enforceability may render the entire appellate process futile. In addition, the Federal Administrative Court's practice not to second-guess FINMA's discretionary decisions and the Federal Supreme Court's limited power of review make it difficult for any appellant to prevail in the Courts. This unsatisfactory situation may have encouraged FINMA to increase the use of its powerful tools recently. Legislative action is necessary to strengthen party rights and to assure an effective judicial control of FINMA's actions.

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Accounting to Clients for Trailer Fees and Inducements— The Decision of the Swiss Supreme Court 4A_127/2012 and 4A_141/2012 of 30 October 2012 and its Regulatory Consequences

Reference: CapLaw-2012-52

In a recent decision of 30 October 2012, the Swiss Supreme Court held that banks are, as a matter of principle, obliged to account to their clients for inducements and trailer fees they received in connection with portfolio management agreements. Moreover, in the wake of this decision, FINMA issued guidance to all banks requiring them to inform all affected clients of this decision and implementing appropriate procedure to respond effectively to client claims.

By Rashid Bahar

1) Introduction

Financial institutions are often at the junction between clients and the financial industry: on the one hand, they help their clients choose investments and manage their portfolio. On the other, they work hand in hand with producers of financial products helping them promote and distribute funds and structured investment products in consideration for placement fees, distribution fees and non-monetary benefits. These payments have long been the subject of a controversy under Swiss law as to the applicability of the duty to account for profits under article 400 (1) of the Code of Obligations (CO).

In a recent decision of 30 October 2012, the Swiss Supreme Court held that banks are, as a matter of principle, obliged to account to their clients for inducements received when acting as a distributor of financial products (BGE 4A_127/2012 and 4A_141/2012 of 30 October 2012). This decision goes against the view of a part of the industry, who had argued until then that trailer fees or ongoing distribution fees paid by funds *(Bestandespflegekommissionen)* were not subject to the duty to account. This decision was, however, just a prelude to a more significant move. On 26 November 2012, the Swiss Financial Market Supervisory Authority FINMA (FINMA) issued a communication requiring banks to inform their clients of their rights following this decision and take further measures to enable them to have an effective access to justice (FINMA Newsletter 41/2012 of 26 November 2012). These two recent developments, which are at the centre of this article, are likely to leave a lasting mark on the Swiss financial industry.

2) The Swiss Supreme Court Decision of 30 October 2012—Distribution Fees Received in Connection with a Portfolio Management Agreement are Inducements

In the case at hand, the bank acted as an asset manager for the client under a portfolio management agreement. In this capacity, it had invested the assets of the clients in various funds and structured investment products. In 2007, the client asked the bank to account for all fees and commissions it received in this capacity. The bank refused to do so, arguing that the placement fees and commissions it received were the consideration for the service of the bank and were not profits realized by the bank in connection with its mandate for the client.

Hearing the matter on appeal from the Superior Court of the Canton of Zurich, the Swiss Supreme Court confirmed that a bank acting as an asset manager, as any agent under a mandate agreement, owes under article 400 (1) CO a duty to account for any benefits it receives in connection with the performance of the agreement. It held further that this obligation applied to all indirect benefits received in connection with the performance of the mandate, such as rebates, commissions or kick-backs, regardless whether the third party intended to give such benefits to the client or not (BGE 4A_127/2012 and 4A_141/2012 of 30 October 2012, E. 4.2).

The Swiss Supreme Court then moved on to address the controversy at hand: whether ongoing distribution fees *(Bestandespflegekommissionen)* are paid in connection with the performance of the portfolio management agreement and are, consequently, covered by the duty to account. After highlighting that the duty to account for profits was an extension of the duty of loyalty, the Swiss Supreme Court argued that accounting for profits was necessary whenever such benefits threatened to induce the agent to disregard the interests of the principal (BGE 4A_127/2012 and 4A_141/2012 of 30 October 2012, E. 5.3). Therefore, since inducements for distributing investment products were likely to skew the incentives of an asset manager, such payments qualified as benefits received in connection with the agreement and were, thus, covered by the duty to account for profits. This characterization applies regardless whether the distribution fees were appropriate or in line with market practice. Indeed, the duty to account for profits was not even conditioned on a breach of the duty of loyalty (BGE 4A_127/2012 and 4A_141/2012 of 30 October 2012, E. 5.7) and would prevail over any regulatory duty to treat investors equally, since a financial institution could set up its business in a way to comply with both duties (BGE 4A_127/2012 and 4A_141/2012 of 30 October 2012, E. 5.8.2).

Furthermore, overturning the appellate decision, the Swiss Supreme Court also held that the duty to account for profits extends to payments within a group of companies considering that, notwithstanding the economic ties that exist in such a context, a conflict of interest would also arise if distribution fees flow from a related entity. Moreover, the court considered that, insofar as the bank needed to consider all possible investments when managing the assets of a client, limiting the duty to account for profits to third party products would skew the incentives in favor of financial instruments produced by the affiliates of the bank (BGE 4A_127/2012 and 4A_141/2012 of 30 October 2012, E. 8.5).

Finally, the court confirmed its previous decisions in respect of a waiver of the duty to turn over benefits received in connection with a mandate agreement. It, therefore, held that the client could validly forgo his rights only if the bank disclosed the drivers of its compensation and their relation with the overall remuneration of the bank, *e.g.* by disclosing the range of the commissions it would be allowed to receive in terms of a percentage of the assets under management. It added that, to be valid, the disclosure needed to be sufficiently specific for the client to assess the extent of the conflict of interests. Therefore, logical upper bound set by the amounts received by the fund management company as a management fee would not meet this requirement (BGE 4A_127/2012 and 4A_141/2012 of 30 October 2012, E. 6.3).

Overall, while this decision confirms to a large extent the two leading cases on retrocessions (BGE 132 III 460 and 137 III 393), it settles the controversy on the duty to account for distribution fees in favor of clients and made it clear that this duty applied also to profit allocation within a group of companies, regardless whether these payment flows were driven by regulatory or tax-related considerations. The Swiss Supreme Court, however, expressly limited the scope of its holdings and stated explicitly that it would not necessarily come to the same conclusion in cases where the bank assumed a more limited role, *e.g.* merely executing orders of the client in an execution-only relationship (BGE 4A_127/2012 and 4A_141/2012 of 30 October 2012, E. 5.5). Thus, it remains to be seen how the court would treat distribution fees paid in connection with execution-only clients and advisory clients. Moreover, the court also recognized that, while the purpose of the duty to account was to bar the bank from realizing a secret profit, article 400 CO entitled the bank to be indemnified for any costs incurred in connection with the mandate and that, consequently, if the bank were in a position to evidence any expenses incurred for the distribution of the fund, it would be entitled to be compensated (BGE 4A_127/2012 and 4A_141/2012 of 30 October 2012, E.5.8). Nevertheless, this decision is likely to leave a longstanding trace in the financial industry.

3) Regulatory Duty to Inform Clients

While the decision of the Swiss Supreme Court of 30 October 2012 sent a shockwave through the industry, the reaction of FINMA was even more surprising: in the wake of the Swiss Supreme Court Decision of 30 October 2012, FINMA raised the stakes. It published a newsletter addressed to all banks in which it sketched what it expected banks to do from a regulatory perspective (FINMA Newsletter 41/2012 of 26 November 2012). After summarizing the key holdings of the decision, FINMA stated that it considered that many banks were likely to be affected by the decision and argued that, while the enforcement of civil claims of clients did not fall within its remit, it expected regulated institutions to uphold their obligations under civil law. Consequently, FINMA concluded that it expected banks to:

– take promptly account of the Swiss Supreme Court's decision for current business activities;

– contact all their clients who are potentially affected and inform them about the court decision to ensure transparency;

– provide these clients with the coordinates of the contact point within the bank with which they can then get in touch for further information; and

– inform the clients upon request about the amount of inducements received by the bank.

In other words, the FINMA acting as a regulator considered that it would not permit regulated institutions to disregard their obligations under civil law now that the highest court of the land had ruled on this issue. Consequently, FINMA instructed banks to inform their clients of their rights and to provide them with means to receive an effective redress.

At this stage, certain questions remain open: does FINMA expect all institutions that received distribution fees to inform their clients or should only institutions that did not secure a valid consent act? Should all clients be informed or can a bank limit its actions to clients who entered into a portfolio management agreement, without informing execution-only clients or even advisory clients? To what extent are banks expected to take active steps with respect to former clients, whose contact details may be unknown to the bank?

In any event, this reaction surprised many financial institutions. It is, however, not as unusual as several commentators seem to believe: while Swiss financial regulations do not expressly oblige financial institutions to set up an effective process to handle customer claims, this step echoes the obligations provided for by article 10 of the MiFID level 2 Directive, which provides that financial institutions must establish, implement and maintain effective and transparent procedures for the reasonable and prompt handling of complaints received from retail clients. Moreover, this is not the first time the Swiss regulator seeks to improve the enforcement of civil claims using its regulatory powers. The Swiss Federal Banking Commission, FINMA's predecessor, repeatedly stated in connection with front-running and mispricing cases that serious breaches of contractual duties were also breaches of regulatory obligations to ensure a proper conduct of business (see, *e.g.,* BGE 108 Ib 201, E. 2b, aa; EBK Bulletin 18 (1988), p. 16; EBK Bulletin 20 (1990), p. 25). In the *Biber* case, it even ordered banks to set up a compensation fund to indemnify clients following a large-scale case of market abuse, although the validity of this measure was questioned by the Swiss Supreme Court at the time (see BGer, EBK Bulletin 40 (2000), p. 37, E. 9d, p. 75–77 questioning the validity of the measure).

Nevertheless, this measure has a truly unprecedented scope. In other cases, the actions of the regulator were limited to specific institutions that were found to have breached their obligations. By contrast, based on the guidance set forth in the newsletter, FINMA expects all regulated institutions to take active steps to determine whether the Swiss Supreme Court's decision applies to them and to proactively inform potentially affected clients of their rights.

Therefore, this measure is likely to be more than an isolated decision in a highly controversial area and gives an insight as to the powers FINMA may aspire to receive to ensure access to justice for retail clients under the upcoming financial services act, which is currently being prepared by the Federal Department of Finance.

4) Outlook

In any case, after these two developments, the controversy surrounding inducements is far from being settled. First of all, although the scope of the duty to account is now clear in connection with portfolio management agreements, it remains to be seen if these precedents will be extended to advisory agreements and to pure execution-only relationships. Since inducements are just as likely to skew the advice provided by a bank than to induce a bias in the investment decisions, they are very likely to be also subject to the duty to account for profits in connection with advisory services. By contrast, a case can still be made that execution-only relationships are not covered by this precedent, because the bank is not instructed to choose the investment product but merely to execute an order and, therefore, does not receive the distribution fee in connection with its mandate for the client. Nevertheless, all three relationships are based, formally at least, on a mandate agreement which entails a duty to account for profits.

Second, another question that has been heavily debated is the scope of the statute of limitation: is the duty to account for distribution fees subject to a five year statute of limitation as for other recurring obligations or is it—to the contrary—subject to a ten year statute of limitation, which, taking the most pessimistic stance for the banks, starts to run only once the agreement has been terminated, as the Superior Court of the Canton of Zurich has argued? Until now, the Swiss Supreme Court did not need to consider this question and thus the issue remains unresolved.

Finally, the Swiss Supreme Court did not challenge the validity of inducements and allows clients to waive their rights to receive such payments provided they are sufficiently transparent. It held that a valid consent would presuppose that the client is informed of the parameters determining the amount of commissions to be paid and their relationship to the overall fees charged to the client for the services of the bank, *e.g.* by disclosing the range of the inducements as a percentage of the assets under management (BGE 4A_127/2012 and 4A_141/2012 of 30 October 2012, E. 6.3; see also BGE 137 III 393, E.2 4). However, such a waiver is not likely to cover the duty to account for profits in its narrow meaning. Financial institutions, even if they secured a waiver from their clients will probably need to detail the benefits they received from third parties in connection with the portfolio management agreement. Since most financial institutions are not set up to deal with such detailed accounting, this is likely to mean that financial institutions may need to go through a costly and tedious exercise of allocating various benefits to specific clients.

In any event, the future of this set-up is uncertain considering international developments: the UK Financial Services Authority has already decided to ban such payments from 30 December 2012 on and the European Union in connection with the proposed MiFID II rules are one step further and propose to allow Member States to issue an outright ban on such payments considering that they are incompatible with independent investment advice and portfolio management (Art. 24 (5) of MiFID II, COM 2011/0298 (COD) as amended by the European Parliament). Therefore, it remains to be seen whether Swiss courts, FINMA or parliament will take another step to restrict the use of inducements in the financial industry. In other words, developments were certainly not the last ones in the long story of inducements in the financial industry.

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Takeover Board Opts-in Again Into the Opting-Out and Revives the Selective Opting-Out

Reference: CapLaw-2012-53

Opting-out has been the most discussed topic in Swiss takeover law since its entry into force in 1998. At the core of the debate has been the question as to who should regulate the right to opt-out from the mandatory offer obligation–the civil courts, the Takeover Board or both? On 11 October 2012, the Takeover Board (TOB) issued a decision in the matter Advanced Digital Broadcast Holdings SA (decision 0518/01), whereby the TOB stated that (i) it would review itself whether the introduction of the opting-out prejudices the rights of minority shareholders by examining the votes of these minority shareholders at the general meeting introducing such opting-out (departing from the LEM Holding SA decision of 22 September 2011) and that (ii) an opting-out could also only apply to a specific transaction/shareholder, thereby allowing the introduction of the so-called selective opting-out (confirming its ESEC Holding AG recommendation of 6 June 2000, but departing from the decision of the Federal Banking Commission of 23 June 2000 in the same matter). No recourse has been filed against the decision of the TOB; it is therefore final.

By Frank Gerhard

1) The Statutory Regime of the Opting-Out

Any shareholder exceeding the threshold of 33.33% of the voting rights in a Swiss company with a primary listing on a stock exchange in Switzerland must launch a mandatory offer for all outstanding shares of the target (article 33 Stock Exchange Act (SESTA)). However, shareholders may exclude generally the application of the rules on the mandatory offer by introducing a so-called "opting-out" (article 22 (2) and (3) SESTA) in the articles of incorporation by a resolution of the shareholders' meeting adopted by a simple majority of the votes represented (article 703 Code of Obligations (CO)). This opting-out is a Swiss specialty: the laws of no other European jurisdiction provide for a mechanism through which the shareholders of a listed company can elect to "opt-out" *generally* from the mandatory offer regime. In fact, the Swiss regime on the opting-out goes further than permitting an exemption/whitewash in a certain specific situation (see *e.g.,* article 32 (2),(3) and (6) SESTA and article 38 and 39 FINMA Stock Exchange Ordinance (SESTO-FINMA)): once validly introduced, an opting-out is valid for any acquirer, for an unlimited period of time (assuming no subsequent deletion from the articles of incorporation) and irrespective of the reason why such an acquirer has exceeded the mandatory offer threshold. If the introduction of such opting-out is made after the listing, article 22 (3) SESTA requires additionally that such opting-out shall not prejudice the interests of the shareholders within the meaning of article 706 CO. Accordingly, shareholders may decide to opt-out from the mandatory offer obligation after listing if such decision would not (i) withdraw or restrict the rights of the shareholders in breach of the law or the articles of incorporation (article 706 (2) (1) CO), (ii) withdraw or restrict the rights of shareholders in an improper manner (article 706 (2) (2) CO), (iii) give rise to an unequal treatment of, or an advantage to, shareholders in a manner not justified by the company's purpose (article 706 (2) (3) CO) or (iv) revoke the profit-making orientation of the company without the consent of all shareholders (article 706 (2) (4) CO).

In order to better understand the importance of the ADB decision, we will briefly set forth below the most important milestones of the practice regarding the introduction of an opting-out after the listing of the company. A more detailed overview can be found in CapLaw 5/2011 (Frank Gerhard, Takeover Board Opts-Out From Opting-Out, p. 11ss).

2) The Development of the Opting-Out Doctrine

The first relevant case regarding the opting-out was the ***ESEC Holding AG/Unaxis Holding AG*** case in 2000 (Recommendation 0018/02 of the TOB dated 6 June 2000). Faced with the question whether an opting-out limited in time (14 months) and limited to one specific acquirer (Unaxis) was valid, and to have such provision vetted by the non-conflicted shareholders in a special meeting, the TOB decided in the affirmative, because the question put forward was whether the mandatory offer obligation was applicable—which was clearly a question of takeover law—and, in order to answer such question, the TOB had to determine whether the shareholders' resolution was valid, and, in order to make such determination, whether the opting-out provision was compatible with the general standards of corporate law enshrined in article 706 CO. Interestingly, the TOB concluded that if the opting-out provision was approved by both the general meeting and a special meeting of non-conflicted shareholders (*i.e.,* the shareholders who would ***not*** benefit from the introduction of the opting-out provision) there would be no reason to challenge the resolution for non-compliance with the general principles of corporate law. In other words, a proper procedure would presume that the substance of the resolution was correct. Yet, the FBC (Decision of the FBC dated 23 June 2000) overturned the TOB's decision and held that an opting-out provision which is only in favor of a specific acquirer or in view of a specific transaction (*i.e.,* a selective opting-out) is not permissible under Swiss law, whether or not the provision was approved by a special majority of the non-conflicted shareholders. The FBC insisted on the *numerus clausus* of the possibilities offered by the SESTA to waive the mandatory offer. In other words, the general and specific exemptions from the mandatory offer obligation (which were not applicable *in casu*) on the one hand, and the opting-up and the opting-out provisions which are, based on the wording of article 22 (2) and (3) SESTA, applicable to all acquirers and not limited in duration on the other hand, leave no room for such a formally selective cherry-picking.

In the 2004 case ***Adval Tech Holding AG,*** the TOB draw the conclusion from the FBC ruling in the ESEC case that a formally general opting-out provision, but in fact introduced in view of a specific acquirer or a specific transaction—even if such acquirer or transaction was not explicitly disclosed—is not enforceable under the takeover law: indeed, it was tantamount to a selective opting-out and therefore violated the principle of equal treatment of the shareholders because it did not benefit all shareholders. Against this background, any opting-out provision introduced within five years prior to a change of control would be deemed introduced in favor of a specific acquirer or a specific transaction and thus be selective in fact (Recommendation 0184/01 of the TOB dated 3 March 2004 in the matter Adval Tech Holding AG, confirmed by the Recommendation 0203/01 of the TOB dated 7 July 2004 in the matter Société de Gares Frigorifiques et Ports Francs de Genève SA).

In 2010, the TOB rendered two decisions that adopted a more relaxed approach. In the ***CI Com SA*** case (Decision 0437/01 dated 4 March 2010), the TOB held that although the opting-out clause at stake was introduced only three years prior to a change of control, such clause was not selective in fact, *i.e.,* was not introduced in view of a specific acquirer or a specific transaction whose identity, even though not explicitly named, was implicit in light of the circumstances. In addition, and more importantly, the TOB held that the mere fact that an opting-out clause was introduced by a majority shareholder and would preponderantly benefit such majority shareholder (indeed, CI Com SA had a 60.9% shareholder at the time of the introduction of the opting-out) does not invalidate such clause ***from a takeover law point of view.*** In such a situation, it would be clear to the other shareholders from the outset that such a majority shareholder would benefit from an opting-out; under these circumstances, it is not necessary to extend the protection granted by article 706 CO et seq. through a mechanism embedded in the takeover law, but it should be left up to the shareholders whether they want or not challenge within two months the shareholders' resolution before the civil courts.

In the ***COS Computer Systems AG*** case (Decision 0440/01 dated 4 June 2010), the TOB applied a new reasoning. In connection with a strategic review with the purpose of making the company an interesting partner for a reverse takeover, the board of COS Computer Systems AG proposed to its shareholders in 2009 to introduce an opting-out clause into its articles of incorporation—without having a specific acquirer or a specific transaction in mind. A reverse takeover was later completed in 2010, but first contacts with the acquirer were not initiated until ***after*** the introduction of the opting-out clause. The TOB found itself in a different position than in the CI Com SA case, since not only there was no acquirer around at the time the clause was introduced, but also there was no major shareholder who would implicitly benefit from the introduction of the opting-out clause. So the TOB could not use the transparency argument since the shareholders could *per se* not make an educated decision. However, instead of declaring that the clause was not selective because it was not introduced in favor of a specific acquirer or a specific transaction (which would have made it easy for the TOB to declare the opting-out clause valid from a takeover law point of view), the TOB held that an opting-out clause, whether formally selective or selective in fact, could be enforceable ***if it does not prejudice the interests of the shareholders within the meaning of article 706 CO.*** In other words, for the first time the TOB decided to actually look at the substance of the matter by applying the requirements of article 706 CO—thereby accepting that a selective opting-out clause is not *per se* invalid from a takeover law perspective. *In casu*, the opting-out clause was an element of COS Computer Software AG's new strategy and thus justified by an overriding corporate interest. Moreover, no shareholder had challenged the introduction of the opting-out clause in court under corporate law.

In the ***LEM Holding AG*** case (Decision 0490/01 dated 22 September 2011), the TOB reversed its practice instituted by the Adval Tech Holding AG precedent. The TOB qualified an opting-out clause introduced by the AGM of LEM with 71% of the votes represented as being selective in fact, since it benefited *de facto* mainly one specific shareholder, Werner Weber, who owned 27.8% of the voting rights of the company when the opting-out was voted upon request by him. Attendance at the AGM was high with 70.07% of the share capital represented (39.84% of the votes represented (or 27.8% of the outstanding share capital) were held by Mr. Weber). However, the TOB did no longer address the question of whether the clause was in compliance with the corporate principles enshrined in article 706 CO as mentioned above. Instead, the TOB came to the conclusion that the shareholders were *fully informed* when voting in favor of the opting-out clause (the identity and intentions of the shareholder requesting the introduction of the opting-out were known, the consequences of such introduction were explained by the board, the board even recommended rejection of the opting-out) and hence took an *educated decision ("en toute connaissance de cause").* In fact, without counting the votes of Mr. Weber, the opting-out would still have been adopted by 53% of the votes represented at the AGM. In addition, following the shareholders' meeting, any shareholder could have challenged the introduction of the opting-out clause before the civil courts (which no one did). Hence, extending the two months deadline provided by corporate law in article 706 CO et seq. in order to challenge the shareholders' resolution by adding an additional five year period during which the TOB could review the resolution without the two months deadline of corporate law to be complied with, would create a doubling of the legal remedies which is not necessary and would be contrary to the need of the security of transactions.

Finally, in the ***BT&T Timelife AG*** case (Decision 0511/01 dated 8 May 2012), the TOB confirmed the LEM Holding SA practice in a case where the major shareholder, who held 45% of the voting rights of the target at the time of the introduction of the opting-out and was simultaneously chairman of the company, requested confirmation from the TOB that the opting-out (introduced 4 years prior to the request) upon proposal by the board was valid. Indeed, the TOB stated that at that time the board of the company informed fully and in a transparent way the shareholders of the target about the consequences of such opting-out. The board of the target had recommended the adoption of such an opting-out alleging that the subsequent intended purchases by the then biggest shareholder would enhance liquidity of the shares, the opting-out would open the strategic option of a going private and the waiver of the mandatory offer would facilitate the cooperation with other major shareholders. Finally, worthwhile to note was that the opting-out had been adopted by unanimous vote of the shareholders represented at the meeting and had not been challenged. Certainly that this unanimous approval played a central role for the decision-making process of the TOB.

3) The ADB Holdings SA Decision

a) Facts

The ADB Holdings SA case shakes up the principles developed in the LEM Holding SA decision, at least when a "controlling" (as defined below) shareholder is involved in the target or the opting-out has been requested by a shareholder.

The shareholders of ADB Holdings SA adopted an opting-out (the company already had an opting-up) at the AGM of 15 June 2012 at the request of 4T SA which already held 41% of the voting rights in the company. The invitation to the AGM mentioned that in case the opting-out would be adopted any shareholder exceeding the threshold of 33.33% or 49% would not be obliged to launch a takeover offer. It also mentioned that 4T SA intended to increase its stake above 49% if the opting-out were introduced. The board of the company abstained from giving any recommendation. At the general meeting, 90% of the votes represented voted in favor of the opting-out. However, only 52% of the share capital and voting rights were represented, among which were the 41% held by 4T SA. Hence, without the votes of 4T SA, the opting-out was rejected by a majority of 80% (the TOB did not take into consideration the abstentions). These facts differ materially from the cases CI COM SA, COS Computer Systems AG, LEM Holding SA and BT&T Timelife AG, where the opting-out was also approved by the non-requesting or non-controlling shareholders. The ADB shareholders' resolution was however not challenged before the civil courts within the two months statutory deadline. On 31 August 2012, 4T SA requested confirmation from the TOB that any further shares acquired by 4T SA in excess of the threshold of 49% would not trigger the obligation to launch a takeover offer. The board of ADB Holding SA seconded this request.

b) TOB Considerations and Ruling

One year after having established a new practice in the landmark decision ***LEM Holding SA,*** the TOB threw over board such practice and came to the following conclusions:

- First, the TOB will examine itself whether the introduction of an opting-out causes a prejudice to the shareholders which is not justified by the company interest (article 22 (3) SESTA in connection with article 706 CO). This remarkable change is justified by the fact that (i) in cases where a "controlling" shareholder exists, minority shareholders are often not in a position to oppose such introduction when facing such a shareholder at the general meeting, (ii) in cases where a shareholder requests the introduction of an opting-out in order to take directly advantage thereof (*e.g.* in view of a transaction which would trigger a mandatory offer), it is not sufficient, from a Stock Exchange Act perspective, to require full transparency and to rely on the possibility that any shareholder can challenge such a decision before the civil courts in accordance with article 706 CO, and, finally (iii) since the legislator has modified on 28 September 2012 (entry into force: most probably on 1 April 2013) the minimum price rule by excluding the possibility for an acquirer of a controlling stake to offer to the recipients of the takeover offer a lower price than the price offered to other shareholders prior to the launch of the offer (article 32 (4) SESTA), a trend might develop towards the introduction of the opting-out in order to avoid the general application of the modified minimum price rule at all. Hence, the conditions for the introduction of such opting-out must be reinforced.

- Second, when reviewing the resolution of the shareholders against the background of article 706 CO, the TOB will look at the result of the overall vote and at the result of the overall vote *without* the votes of the "conflicted" shareholder(s) (and the shareholder(s) acting in concert). If the other shareholders, *i.e.,* the "minority" shareholders, have also approved the opting-out, the TOB will assume *de facto* that the opting-out is in the interest of the "minority" shareholders and of the company (presumption of correctness), *provided* that in very exceptional cases, such clause could still be invalid and *provided* that any annulment after a challenge according to article 706 CO remains reserved. In this respect, the TOB is back to the same reasoning it held in the ESEC Holding AG recommendation on 6 June 2000. If, however, the "minority" shareholders have not approved the opting-out, the TOB would assume that the opting-out is neither in the interest of the "minority" shareholders nor in the interest of the company, *provided* that in exceptional cases (but we believe probably less exceptional than when both majorities are in favor of the introduction of the opting-out), such clause could still be valid, *e.g.* in case of a recapitalization of the company by the entry of a new investor (see *e.g.* the facts that led to the COS Computer Systems AG decision), and *provided* that any confirmation of the validity of the opting-out after a challenge according to article 706 CO remains reserved.

– Third, when determining who are the "minority" shareholders whose votes will be looked at, the TOB stated that any shareholder holding more than 33.33% of the voting rights (*i.e.,* a "controlling" shareholder) and any shareholder who requested the introduction of the opting-out, in both cases including the shareholder(s) acting in concert, shall be excluded from the relevant votes. Indeed, these shareholders are "conflicted" because they would directly benefit from the introduction of such an opting-out, the first because they could sell their shares without the acquirer being obliged to launch a mandatory offer, the second because they can take control of the company without being obliged to launch a takeover offer for all the shares of the company.

– Fourth, in *all* possible scenarios, the introduction of the opting-out must be preceded by a transparent procedure. Shareholders must be duly informed about the situation, about the intentions of the "controlling" shareholder(s), if any, and of the shareholder(s) requesting the introduction of the opting-out, as well as about the consequences of the adoption of the opting-out. This information must be disclosed in the invitation to the general meeting. If needed, the board shall request from each "controlling" shareholder and from the shareholder(s) requesting such introduction their intention with respect to any transaction that would benefit from such opting-out. If such shareholder(s) would not cooperate, the opting-out would not benefit them from a takeover law perspective.

– Finally, in an *obiter dictum*, the TOB also considered that the practice of the FBC in the ESEC Holding AG case denying any validity to opting-out clauses that are formally selective, *i.e.,* which benefit a specific transaction/shareholder(s) clearly and fully disclosed at the shareholders' meeting, shall be revisited. Indeed, the impact of such a clause—duly adopted by the "majority of the minority" by an educated decision—is of lesser importance than a general opting-out, since "minority" shareholders waive their right to obtain an offer price complying at least with the minimum price rule only in connection with a specific transaction and/or in favor of one or several shareholder(s) that are duly known. They do not waive their rights for a mandatory offer in *any* change of control transaction.

In casu, even though the shareholders of ADB Holdings SA took an educated decision when voting in favor of the opting-out clause since the information provided to them was complete and transparent, the TOB held that the clause was invalid from a takeover law point of view, because it was not approved by the "majority of the minority" and the presumption of invalidity could not be reversed. Indeed, the arguments of the board and of 4T SA were not convincing (increased stability of the shareholder base vs. the shareholder group of 4T SA already held 41% of the voting rights and could increase its stake to 49% without launching a takeover offer; increase of the liquidity of the shares by the purchases to be undertaken by 4T SA vs. this would have only have a short-term effect since additional purchases will in fact reduce the free float and hence the liquidity).

4) Comments

a) Competence of the TOB

Conceptually, the ADB Holdings SA decision is a fundamental change against the LEM Holding SA decision. The TOB will again review opting-out clauses, even if shareholders approved such clause after having been fully informed of the circumstances and the consequences of such approval. However, when the company has no "controlling" shareholder and the request to introduce such an opting-out comes from the board of the company (and not from a shareholder), the new practice should not trigger fundamental changes in its results.

In our discussion of the LEM Holding SA decision, we welcomed the approach whereby the TOB "opted-out" from reviewing questions of corporate law when this can be done by the civil courts because a parallel review of the same facts by various authorities at different moments in time reduces transaction certainty. We still continue to believe so, but we also believe that a literal reading of article 22 (3) SESTA allows the TOB to review the opting-out as well for the following reasons:

– First, article 22 (3) SESTA provides that a company may at any time adopt an opting-out in its articles of incorporation, "provided that this does not prejudice the interests of the shareholders *within the meaning* ('im Sinne von'; 'au sens de') of article 706 CO". This reference to article 706 CO may have several meanings, which have not been discussed during the parliamentary debates and have not been given attention in any of the three ordinances implementing the SESTA. Is it only a reference to a concept of corporate law, *i.e.,* the prejudice of interests of shareholders pursuant to article 706 CO? Or is it also a reference to the competence and procedure set forth in article 706 CO, *i.e.,* if a shareholder wants to challenge such clause, he/she must do this before a civil court within two months after the decision has been taken? At this stage, we believe it is only a reference to a concept of corporate law and not to the competence and procedure set forth in article 706 CO et seq.

– Second, article 23 (3) SESTA provides that the TOB shall, in each case, ensure compliance with the rules applicable to public takeover offers (takeover matters). As of 1 January 2009, the competences of the TOB have been reinforced: According to article 33a (1) SESTA, the TOB shall render the decisions necessary for the enforcement of the provisions of chapter V of the SESTA (takeover matters) and its implementing provisions, and shall monitor compliance with the statutory and regulatory provisions. Hence, not only the duty of the TOB to monitor compliance with the statutory and regulatory takeover law provisions has been repeated, but also the competence to issue decisions pursuant to the Federal Act on Administrative Procedure (FAAP) and the applicability of the FAAP to the procedures before the TOB have been declared. Finally, article 33a (3) SESTA provides that if the TOB becomes aware of breaches of provisions of chapter V of the SESTA or of other irregularities, it shall ensure that an orderly situation is restored and that such irregularities are remedied. The amendments of 2009 have fundamentally modified the status of the TOB: from a self-regulatory commission only capable to issue recommendations with a limited enforcement power, it has become a fully-fledged authority with the power to act *ex officio*, the competence to issue binding decisions according to the FAAP and the power to enforce them under certain circumstances.

Against this background, which was not contemplated when the Parliament adopted article 22 (3) SESTA, it becomes clear that at least since 1 January 2009 the TOB may also review whether the adoption of an opting-out clause prejudices the interests of the shareholders *within the meaning* of article 706 CO. This is the consequence of the TOB being a fully fledged authority with the duty to monitor compliance with the statutory and regulatory provisions and equipped with full intervention and decision-issuance competence.

b) Intervention of the TOB—Parallel Procedures

Even though the literal wording of article 22 (3) SESTA supports the view that the TOB is competent to review the introduction of an opting-out clause in a specific case, we think that the protection offered by the LEM Holding SA test of full information of the circumstances and the consequences of such approval was sufficient and enhanced the security of transactions by avoiding parallel procedures.

We believe that the argument that "minority" shareholders are often not in a position to oppose such adoption when facing a "controlling" shareholder at the general meeting is not relevant, as by definition, a general meeting is a capitalistic assembly governed by the majority votes of the represented or present shareholders, which do not owe any duty of loyalty neither to their other fellow shareholders nor to the company. Developing this reasoning further could reverse the democratic legitimacy within a corporation by systematically listening to the minority shareholders, even in cases where their interests are not at stake or are aligned with those of the majority shareholder(s). Further, we believe that the possibility that any shareholder may challenge such a decision before the civil courts in accordance with article 706 CO et seq. is a sufficient corrective to protect the rights of the "minority" shareholders against an unequal or abusive treatment imposed by a "controlling" shareholder. It is true that shareholders only seldom challenge in court the resolutions of the general meeting and the courts themselves are reluctant to annul shareholders' resolutions. However, affirming this is basically negating any efficiency to the remedies of the Code of Obligations that are available to minority shareholders in order to fend for themselves when a majority shareholder is abusing its power. Hence, we believe that the main reason that has pushed the TOB to revisit the LEM Holding SA practice (as stated by the TOB itself) is actually a political motivation: preventing that companies use heavily the means of the opting-out in the future in order to avoid being subject to the modified minimum price rule which will exclude the possibility for an acquirer of a (controlling) stake to offer to the recipients of the takeover offer a lower price than the price offered to other shareholders prior to the launch of the offer (article 32 (4) SESTA).

Shareholders are fully informed, *e.g.,* when a "controlling" shareholder clearly identified would immediately benefit from the clause when selling its shareholding (*e.g.,* CI Com SA matter, where the shareholder owned more than 33.33% at the time of the adoption of the opting-out clause; BT&T Timelife AG, where the shareholder owned 45% at the time of the adoption of the opting-out clause), or when the shareholder requesting the introduction of the opting-out announces his/her intention to exceed the mandatory offer threshold and thereby benefits directly from such a clause (*e.g.,* LEM Holding SA, where the shareholder owned 27.8% at the time of the adoption of the opting-out clause; ADB Holdings SA, where the shareholder owned 41% at the time of the adoption of the opting-out clause (in the last case, the mandatory offer threshold was 49% since the company already had an opting-up)).

In our view, the only reason for the TOB to intervene should be to protect the shareholders who voted on the introduction of an opting-out *without* being sufficiently informed about the perspective of a specific transaction or the intention of a specific shareholder. Indeed, if such undisclosed transaction or intention is then completed (by such a "controlling" shareholder or a shareholder requesting the introduction of the opting-out) more than two months after the approval of the opting-out clause, the "minority" shareholders are no longer able to challenge such approval and their waiver of the mandatory offer and of the minimum price rule shall no longer be valid from a takeover law perspective. In such case, as the TOB rightly declared, such opting-out would be invalid from a takeover law perspective. However, we are of the view that for the reason of transaction security the five years cooling-off period set up by the TOB in the Adval Tech Holding AG recommendation is still applicable. The TOB should not review at all opting-out clauses that are older than five years. Also, referring to one of the arguments put forward by the TOB for the change of practice, namely the amendment to the minimum price rule, this could be seen as a transitory period in connection with such change in law.

c) "Majority of Minority" as a Procedural Presumption and Substantive Test

If the TOB has the competence in principle to review the validity of the opting-out under article 22 (3) SESTA, the question remains when the TOB shall use this competence and what rules the TOB shall apply when reviewing such opting-out. We are of the opinion that the reference to article 706 CO is a direct reference to general principles of corporate law and that the TOB must apply such principles when reviewing an opting-out clause. Hence, if there should be a room for the presumptions set up by the TOB, we believe that the presumption of correctness or incorrectness should be a procedural presumption (whether the TOB should review the introduction of the opting-out or not—analogical with the five years test of Adval Tech Holding AG) rather than a presumption as to the validity of the opting-out itself.

According to the presumption of correctness set up by the TOB, the opting-out is presumed in the interest of the "minority" shareholders and of the company if the "minority" shareholders have also approved the opting-out (not taking into account the abstentions). In such case, the TOB will deem the opting-out in compliance with article 706 CO. From a corporate law perspective, looking at the votes of the "minority" shareholders as a group might at the most be an indication whether or not conflicting shareholders' interests exist, but not necessarily whether such a decision is "correct" as to its content. Indeed, the consequences of such a presumption of "content" correctness are rather unclear in case a "minority" shareholder challenges nevertheless the shareholders' resolution before a civil court. In our view, it cannot be a presumption in the technical sense (which would have an impact on the burden of proof or on the assessment of evidence): Before a civil court, the presumption could only mean that such court would no longer review whether the shareholders' resolution is not objective *(sachlich)* or appropriate *(angemessen)* pursuant to article 706 (2) (2) CO. However, the presumption could not be applied in order to determine whether an unequal treatment according to article 706 (2) (3) CO occurred: If a "minority" shareholder challenges the resolution of the shareholders' meeting even though a "majority of the minority" has approved such resolution, the court would still have to review (i) whether an unequal treatment occurred and (ii) whether such unequal treatment was justified by valid reasons. Hence, the "content" presumption set up by the TOB cannot be based on article 706 CO. Further, if the TOB looks into the matter, it must investigate *ex officio* and may freely assess evidence—irrespective of the overall vote of the "minority" shareholders. The only possibility to justify such a presumption of correctness would hence to qualify it as a "procedural" presumption (*i.e.,* whether the TOB should review the introduction of the opting-out at all or not) based on the administrative rules applicable to the procedure before the TOB and justified by the special position of the TOB.

Further, the TOB assumed that the opting-out clause is not in compliance with article 706 CO if the majority of the "minority" shareholders voted against the its adoption (not taking into account the abstentions) and only exceptional circumstances can overturn this presumption (presumption of incorrectness). According to our opinion, this point of view is not compatible with article 706 CO because this would mean that the introduction of an opting-out clause depends on the approval of a special group of shareholders (*i.c.,* the "minority" shareholders). However, such additional approval by a special group of shareholders does not exist, except for particular cases provided for by statutory law (for example in article 654 (2) CO). It is only foreseen where statutory law grants special rights to a group of shareholders *and* an additional mechanism is provided in order to protect these rights. Introducing as prerequisite an additional approval of a special group of shareholders would however be against the ratio of the existing corporate remedies mechanisms. The TOB needs to actually look at the substance of the matter by applying the requirements of article 706 CO. Both formally selective and selective in fact opting-out clauses can be considered as unequal treatment of shareholders since they advantage a specific shareholder or a specific group of them. Nevertheless, this cannot *per se* lead to the conclusion that a selective opting-out clause is presumed to be incompatible with the law as article 706 CO only addresses an unequal treatment which is not covered by valid reasons. The interpretation of what can be considered a valid reason cannot depend upon the opinion of a special group (in case the "minority" shareholders) but has to be assessed from an objective point of view.

For instance, we believe that the opting-out requested by a shareholder in order to exclusively avoid launching a mandatory takeover offer and to sell his/her stake to an acquirer without forcing the latter to launch a mandatory offer either, hence allowing him/her to collect potentially the entire premium for the control over the target will probably not pass the test of article 706 CO. Indeed, in order to obtain the approval of the minority shareholders and hence being within the procedural presumption proposed above, the requesting shareholder or the company will have to explain why such opting-out clause contributes to reaching the goal set by the company or is not aiming at favoring the interests of certain specific shareholders, and is proportionate, *i.e.,* is adequate and necessary in order to pursue the interest of the company and the advantages to the company supersede the interests of the minority shareholders. The mere privatization of the control premium—without any overwhelming corporate interest—will not justify the introduction of the opting-out clause.

Even if the opting-out is introduced (i) within the five years presumption period and (ii) refused by the "majority of the minority" (but approved by the general meeting), the assessment could, however, be different if the opting-out is introduced by a target in connection with a general strategic review (*e.g.*, the COS Computer Software AG case) or in connection with a specific corporate transaction (*e.g.*, ESEC Holding AG, where the shareholder owned 13.28% and intended to exercise a call option to reach 76.66%): the introduction would be based on a valid reason and any disadvantages incurred by the shareholders could be justified by the overwhelming corporate interest of such a target to achieve, *e.g.*, such merger or acquisition.

d) Formally Selective Opting-out

The last example above of the issuance of new shares in connection with a corporate combination—dealt with in the UK within the whitewash procedure—is a very good example why we believe that a formally selective opting-out should be permitted. We share the view of the TOB in that respect and hope that the FINMA will depart if seized in the future with the question from the practice it created in the ESEC Holding AG case twelve years ago. The principle *"a majore ad minus"* should also be applicable in the case of the introduction of an opting-out. Not only it would enable transactions that can be in the interest of the target adopting the opting-out, but also it would actually follow the principle of proportionality *("schonende Rechtsausübung")*, as only a specific (new) shareholder/transaction would benefit from the opting-out. The "minority shareholders" would waive their right to sell their shares at a minimum price only in presence of a specific transaction about which they must be fully informed. Any subsequent transaction or transfer would again trigger the mandatory offer.

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Update on Over-The-Counter (OTC) Derivatives Legislation in the US

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The financial crisis has brought the derivatives to the forefront of regulatory attention. In 2010, as a response, the US enacted the Dodd-Frank Act which provides for new Federal regulation of the swaps market and is expected to make fundamental changes in the way the swaps market operates. Many sections of the Dodd-Frank Act require significant rulemaking by the SEC and CFTC. This article provides an update on recent developments and current status of such rulemaking.

By Thomas Werlen / Stefan Sulzer

On 21 July 2010, President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) into law (see already CapLaw 2010-34 and CapLaw 2010-47). Title VII of the Dodd-Frank Act provides for new Federal regulation of the swaps market, and, when fully implemented, is expected to make fundamental changes in the way the swaps market operates. The most significant of these changes include (i) mandatory clearing of certain derivative instruments through regulated clearing organizations and mandatory trading of certain derivative instruments on regulated exchanges or swap execution facilities; (ii) regulation of derivatives market participants; and (iii) divestment or "push out" of banks' swap activities. The new framework seeks to reduce systemic risk, increase transparency and improve efficiency in the swaps market.

Those provisions of Title VII of the Dodd-Frank Act that do not require implementing regulations became automatically effective one year after the enactment of the Dodd-Frank Act, *i.e.* on 16 July 2011. Those provisions that require implementing regulations will not become effective until at least 60 days after final rules are published. Many of the Title VII implementing regulations have been proposed, only a few are finalized. Foreign regulators and foreign financial institutions doing business in the United States have raised substantial concerns regarding the extraterritorial effects of a number of the proposed rules. Many agencies have acknowledged that a phased, or staged, implementation process is required given the possibility for market disruption. On 11 June 2012, the U.S. Securities and Exchange Commission (SEC) issued a policy statement describing the order in which it expects new rules regulating security-based swaps would take effect. The policy statement does not estimate when the rules would be put in place, but describes the sequence in which they would take effect. Because of the sweeping nature of these changes, the market transition contemplated by the Dodd-Frank Act is expected to take several years to be implemented fully.

Set forth below is a summary of recent developments and current status of some of the most notable areas of rulemaking in connection with the implementation of Title VII of the Dodd-Frank Act.

Definition of Swaps. The definition of the term "swap" is of utmost importance with respect to the implementation of Title VII of the Dodd-Frank Act because it determines the scope of products to be regulated by the SEC and the U.S. Commodity Futures Trading Commission (CFTC). In the Dodd-Frank Act, the term "swap" is defined broadly; it includes, among other things, certain foreign exchange transactions, such as non-deliverable foreign currency forwards, that may not be characterized as swaps for other purposes. The Dodd-Frank Act mandates that the SEC and CFTC, in consultation with the Federal Reserve Board, jointly "further define" the term "swap". On 13 August 2012, the SEC and CFTC published their joint final rules further defining the term "swap." To quell concerns of the insurance industry, the SEC and CFTC have indicated that they did not interpret the term "swap" to include those products that have historically been regulated as insurance and the final rules therefore include safe harbor provisions which exclude certain insurance products from regulation under Title VII of the Dodd-Frank Act.

Significant Market Participants. New Categories. The Dodd-Frank Act creates two new categories of significant market participants: "swap dealers" and "major swap participants." Effective 23 July 2012, the SEC and the CFTC adopted joint final rules defining those terms. Persons that meet these definitions are subject to statutory requirements related to, among other things, registration, margin, capital and business conduct. Swap dealers and major swap participants are required to register with either or both the SEC and CFTC, depending on the categories of swaps in which they transact.

Registration. In March 2012, the CFTC adopted regulations that establish the process for the registration of swap dealers and major swap participants. The regulations went into effect on 12 October 2012. However, on 10 September 2012, in response to market uncertainty, the CFTC issued a release stating that market participants will not be deemed to be swap dealers, and therefore will not have to register, before 31 December 2012, at the earliest. The SEC has proposed similar registration rules for security-based swap dealers and security-based swap participants on 12 October 2011, but has not yet adopted final rules.

Business Standards. In December 2010, the CFTC proposed rules prescribing external business standards for swap dealers and major swap participants. Under these rules, which became effective on 17 April 2012, swap dealers and major swap participants must, among other things: (i) verify that each counterparty is an eligible contract participant; (ii) provide potential counterparties with certain required disclosures; (iii) provide daily marks in certain circumstances; (iv) notify counterparties of their right to clear swaps or select a derivatives clearing organization in certain circumstances; and (v) communicate with their counterparties in a fair and balanced manner.

On 29 June 2011, the SEC issued its proposed business conduct rules for security-based swap dealers and security-based major swap participants, substantially identical to those issued by the CFTC swap dealers and major swap participants. These SEC rules have not yet been finalized.

Mandatory Central Clearing. To help reduce the systemic risk associated with OTC derivatives transactions, Title VII of the Dodd-Frank Act requires many swaps to be submitted for clearing to a CFTC- or SEC-regulated clearing organization. The types of swaps that will be subject to Dodd-Frank's clearing requirement will be established by SEC and CFTC rule-making, but in any event won't be required to be cleared until they are accepted for clearing by at least one central clearing counterparty. Neither the CFTC nor the SEC has yet mandated that any swap be cleared. However, on 24 July 2012, the CFTC proposed its first clearing mandate for swaps, mandating clearing of four classes of interest rate swaps and two classes of index credit default swaps. On the same day, the CFTC finalized rules establishing a schedule for compliance with the mandatory clearing requirements for swaps. These rules became effective on 28 September 2012. The CFTC's clearing implementation schedule provides that the clearing requirement will become effective for swaps involving a non-financial end-user party no less than 270 days after the effective date of a final clearing requirement determination for that particular class of swaps.

On 28 June 2012, the SEC has adopted rules relating to mandatory clearing of security-based swaps, detailing how clearing agencies will provide information to the SEC about security-based swaps they plan to accept for clearing. The rules describe the information that must accompany each submission so that the SEC will be able to determine whether the security-based swap should be subject to mandatory clearing. Similarly, the CFTC adopted final rules addressing (i) the documentation between a customer and a dealer that clears on behalf of the customer, (ii) the timing of acceptance or rejection of trades for clearing by derivatives clearing organizations and clearing members, and (iii) the risk management procedures of dealers and major swap participants that are clearing members. These rules became effective on 1 October 2012.

Exception to Mandatory Clearing Requirement. The Dodd-Frank Act provides an exception to the mandatory clearing requirement if one of the counterparties to the swap (i) is not a financial entity, (ii) is using swaps to hedge or mitigate commercial risk, and (iii) notifies the applicable regulator how it generally meets its financial obligations associated with entering into non-cleared swaps. On 19 July 2012, the CFTC published final rules addressing the circumstances in which a particular swap would be entitled to the "end-user exception." These rules became effective on 17 September 2012.

However, at this time, the CFTC has not finally determined which swaps will be subject to mandatory clearing and thus noted that compliance with the new rules "will not be necessary or possible until swaps become subject to the clearing requirement". Though the SEC issued proposed end-user rules for security-based swaps in December 2010, it has yet to issue any final rules on the end-user exception.

Reporting and Recordkeeping. The Dodd-Frank Act requires that market participants trading swaps report data concerning their transactions to one or more swap repositories and that they retain certain documentation concerning their positions in swaps. Some of the information concerning swaps will ultimately be required to be disseminated publicly and in real time. The majority of the reporting burden will fall on swap dealers and major swap participants. However, other users of swaps may become subject to extensive recordkeeping requirements, including a requirement that they retain "full, complete and systematic" records with respect to each swap to which they are party. In January 2012, the CFTC published final rules regarding real-time reporting and public dissemination, regulatory reporting and recordkeeping requirements for swap transaction data and in June 2012, it adopted final rules on the recordkeeping and reporting of historical swaps. The SEC's reporting and recordkeeping rules are still in the proposal stage.

Volcker Rule. Section 619 of the Dodd-Frank Act introduces a restriction on proprietary trading by banking groups (the Volcker Rule). The Volcker Rule is an amendment to the U.S. Bank Holding Company Act (BHCA), which generally prohibits entities that are subject to the BHCA from engaging in (i) proprietary trading and (ii) investing in, sponsoring, or controlling hedge funds and private equity funds. Under the Dodd-Frank Act, the conformance period for the Volcker Rule started in July 2012, but the Federal Reserve has indicated that covered entities will have until 21 July 2014 to fully conform their activities with the Volcker Rule.

"Push-out" Rule. Under the Dodd-Frank Act, effective July 2013, subject to certain exceptions, an entity registered as a swap dealer or major swap participant may not receive certain kinds of U.S. federal government assistance, including advances from the Federal Reserve's discount window. U.S. depository institutions therefore would have to "push out" their swap activities to an affiliate that is registered as a swap entity. US branches of foreign banks may also borrow from the Federal Reserve's discount window and may also be subject to the "push out" rule if subject to swap dealer registration.

We will continue to monitor and report on the implementation of Title VII of the Dodd-Frank Act as the legislation evolves.

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Initial Public Offering of EFG Financial Products Holding AG

Reference: CapLaw-2012-55

In the second IPO in 2012 in the Main Standard, EFG Financial Products Holding AG (EFGFP) went public on 19 October 2012 on the SIX Swiss Exchange. EFGFP is an integrated structured investment service provider with a leading position in Switzerland and an international presence through offices in Zurich, Geneva, Monaco, Guernsey, Frankfurt, Paris, Madrid, London, Singapore and Hong Kong. The IPO comprised a public offering in Switzerland and private placements to eligible private and institutional investors abroad.

Statutory Revisions

Reference: CapLaw-2012-56

- ***Liquidity Ordinance:*** In late November 2012, the Federal Council adopted the liquidity ordinance which transforms the Basel III liquidity requirements into Swiss law. It establishes the basis for the introduction of a liquidity coverage ratio (LCR) by 2015 and a net stable funding ratio (NSFR) by 2018 for all Swiss banks. These principles already apply to the two big Swiss banks on the basis of agreements reached with the Swiss Financial Market Supervisory Authority (FINMA) but will be transformed into the ordinance. The ordinance will gradually enter into force from 1 January 2013. The requirements which apply specifically to systemically relevant banks (SIBs) are subject to approval by the Federal Parliament. It is expected that the ordinance will be amended in 2013/2014 to include the final LCR rules on the basis of the final Basel Committee on Banking Supervision (BCBS) rules but including specific FINMA requirements.

- ***Collective Investment Schemes Act and Implementing Ordinance (CISA and CISO):*** It is expected that the revised CISA will enter into force in early 2013. The revised CISA shall enter into force simultaneously with the CISO of which a draft is expected to be circulated for consultation before year-end.

- ***Bank Insolvency Ordinance FINMA (BIO-FINMA):*** BIO-FINMA entered into force on 1 November 2012 (see CapLaw-2012-31).

- ***Insurance Bankruptcy Ordinance FINMA (IBO-FINMA):*** IBO-FINMA will enter into force on 1 January 2013 (see CapLaw-2012-33).