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# New Swiss Rules on Insider Dealing and Market Manipulation entered into force on 1 May 2013

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On 1 May 2013, the new Swiss rules on insider dealing and market manipulation entered into force. They bring about a fundamental change in Swiss administrative and criminal law and will have a significant impact on Swiss practice. Accordingly, issuers, financial institutions, advisers and other affected persons (meaning any other market participant in Switzerland) should familiarize themselves with the new rules and review their internal guidelines, procedures and standard forms to ensure compliance with these new rules and to make appropriate use of the safe harbours available under the new law. Further regulation will follow shortly; in particular, a revised FINMA circular on market behaviour rules, which will apply to all market participants, is expected to enter into force on 1 August 2013.

*By Philippe Weber*

## 1) Introduction

On 1 May 2013, the new Swiss rules on insider dealing and market manipulation entered into force. The main provisions can be found in the revised Stock Exchange Act (SESTA) and the amended implementing Stock Exchange Ordinance of the Swiss Federal Counsel (SESTO). In addition, the Swiss Financial Market Supervisory Authority (FINMA) has conducted a consultation process for a revised FINMA circular on market behaviour rules. The revised FINMA circular is expected to enter into force on 1 August 2013 and will apply to all market participants.

This article discusses the key changes coming with the revised law, namely:

– the ***new administrative law rules on market abuse*** (articles 33e and 33f SESTA), which (i) will be enforced by FINMA, (ii) apply to all market participants (*i.e.,* not only FINMA regulated entities), and (iii) apply irrespective of any intent and financial benefit on the part of any relevant person (differing from criminal market abuse); and

– the ***revised criminal law rules on insider dealing and market price manipulation*** (articles 40 and 40a SESTA), which will be prosecuted by the Swiss federal prosecutor and tried before the Swiss Federal Criminal Court.

In connection with these points, this article will also discuss (i) certain important safe harbours and other exemptions introduced by the Swiss government through the recently published revised SESTO, and (ii) key elements of the draft revised FINMA circular on market behaviour rules, which (1) will provide further guidance on how FINMA intends to apply the new administrative rules on market abuse, and (2) specifies further duties on FINMA regulated institutions.

## 2) The new administrative law rules on market abuse (articles 33e and 33f SESTA)

The revised SESTA introduces a new administrative law regime that prohibits all natural persons and legal entities from engaging in insider dealing and market manipulation. Prior to this, FINMA could only enforce market conduct rules against certain supervised market participants.

### a) What constitutes market abuse *under administrative law*?

Under administrative law, market abuse comprises unlawful dealing with inside information (article 33e SESTA) on the one hand and market manipulation (article 33f SESTA) on the other hand:

#### *i) Unlawful dealing with inside information (new article 33e SESTA)*

Article 33e SESTA states that any person who knows or should know that information constitutes inside information acts unlawful if it:

(a) exploits *(ausnützt* (German)*/exploite* (French)*/sfrutta* (Italian)*)* such information to acquire or dispose of securities admitted for trading on a stock exchange or on a similar platform in Switzerland or if it uses financial instruments derived from such securities; or

(b) communicates such information to another person; or

(c) exploits such information to make a recommendation to another person to acquire, dispose of or use financial instruments regarding any securities covered by paragraph (a) above.

In this connection, the following three points are worth mentioning:

- "Inside information" means any confidential information which, if made public, would be likely to have a significant effect on the price of securities admitted for trading on a stock exchange or on platforms which are similar to stock exchanges *(börsenähnliche Einrichtung)* in Switzerland;
- the term "similar platform" should be limited to alternative trading systems which FINMA has expressly subjected to the SESTA/SESTO pursuant to article 16 SESTO, otherwise market participants would not be in a position to assess whether or not a security falls within the scope of market abuse rules; and
- according to the Swiss government's report of 31 August 2011 which was published together with the draft bill for the revised SESTA, *"exploit"* requires that the transaction was made based on the inside information, *i.e.* transactions which are

done despite the knowledge of inside information, but not based thereon, are not prohibited by article 33e SESTA.

#### *ii) Market Manipulation (new article 33f SESTA)*

Article 33f SESTA states that any person acts unlawful, if it:

(a) publicly disseminates information, of which such person knows or should know that this will send a false or misleading signal in relation to the offer, demand or price of securities admitted for trading on a stock exchange or on a similar platform in Switzerland; or

(b) carries out any transactions or executes buy- or sales orders, of which such person knows or should know that this will send a false or misleading signal in relation to the offer, demand or price of securities admitted for trading on a stock exchange or on a similar platform in Switzerland.

Unlike the criminal offence of market manipulation as defined in article 40a SESTA (and discussed in greater detail below), which only applies to simulated transactions, the administrative law regime will extend to real transactions carried out to manipulate the market for relevant securities. This significantly expands the scope of the provision to cover various manipulative practices such as squeezes, pump and dump schemes as well as naked short selling.

### b) Are there any statutory safe harbours or other (potential) exemptions?

As indicated above, the new administrative law rules on market abuse have been drafted very broadly and, on their face, would also prohibit various accepted market practices. In paragraphs 2 of articles 33e and 33f SESTA, the Swiss government has therefore been authorised by parliament to issue rules on permitted behaviours (so-called "safe harbours").

Based thereon, the Swiss government has adopted a revised SESTO which entered into force on 1 May 2013 and provides several safe harbours as further described below. In addition, in its accompanying report to the revised SESTO the Swiss government provided additional guidance on (potentially) permitted behaviours. Finally, further guidance will be available once the revised FINMA circular on market behaviour has become final and enters into force.

#### *i) Statutory Safe Harbour 1: Share Buy-backs (new articles 55b-d SESTO)*

The new articles 55b-d SESTO contain ***detailed rules on buy-backs*** which, if followed, provide for a safe harbour under market abuse rules.

To a large extent, the SESTO provisions on buy-backs replace the rules previously set forth in the Swiss Takeover Board (TOB) Circular no. 1 about buy-back programmes. Consequently, the TOB has published a shortened Circular no. 1 about buy-back programmes and abolished its Circular no. 4 regarding exchange offers. In addition, the TOB has partially amended its Takeover Ordinance. The new TOB provisions entered into force on 1 May 2013 as well.

According to articles 55b-d SESTO, the safe harbour only applies to shares (*Beteiligungsrechte*). It therefore remains unclear whether and/or how buy-backs of debt securities will be treated under the new regime.

***ii) Statutory Safe Harbour 2: Stabilization upon public offering (new article 55e SESTO)***

According to article 55e SESTO, trading in securities for purposes of stabilization will be permitted pursuant to articles 33e (1)(a) and 33f (1) SESTA, if:

- this occurs within 30 days from the public placement of the respective securities;
- it is made at a price which is not higher than the offer price or, in case of subscription and conversion rights, not above their market price;
- the maximum period during which stabilization may occur and the identity of the securities dealer who has been appointed as stabilization agent have been published prior to start of trading of the relevant security;
- no prices are quoted while trading is suspended as well as during the opening and closing auctions;
- the stock exchange has been notified of any stabilization activities within 5 trading days and the issuer has published notice of such activities within 5 trading days from expiry of the stabilization period; and
- the issuer has informed the public within 5 trading days after exercise of any overallotment option about the time of exercise and the relevant number and type of securities.

According to article 55e SESTO, stabilization in case of public placements is exempt, *i.e.* the exemption would not be available in case of private placements. During the preparation of the revised SESTO, various practitioners had asked the Swiss government to revisit this position, unfortunately without success. In its accompanying report to the revised SESTO, the government justified its position by stating that (i) private placements normally regard non-listed securities, and (ii) in those exceptional cases where listed shares are placed privately, only selected investors would benefit from stabilization, *i.e.* in contrast to public offerings, in private placements one could not invoke the trust of investors generally in financial markets and their functioning to justify an exemption.

This assessment, however, is not convincing. First, private placements of listed shares, including offerings by issuers (whether treasury shares or new shares), are increasingly common in Switzerland. Secondly, in case of offerings of listed securities, not only the subscribers of the offer shares will benefit from stabilization, but also the issuer, existing shareholders and any person who wishes to purchase or sell shares on a stock exchange, because all of them may be affected by short-term fluctuations resulting from the sudden increase in supply. This is particularly true in the case of private placements of new shares, in the case of large private placements of treasury shares and in cases where significant shareholders sell a large stake, which all are typically placed and priced by way of accelerated bookbuilding procedure and without a prospectus (unless the newly issued shares exceed 10% of the existing shares). Therefore, it would be helpful if the Swiss government would revisit its position in connection with the next revision of the SESTO. Pending this, market participants will have to consider whether any particular circumstances of the case may (exceptionally) permit stabilization within the parameters of articles 33e and 33f SESTO, *i.e.* without invoking a statutory exemption; however, this could be very risky both from an administrative and criminal law perspective.

### *iii) Statutory Safe Harbour 3: Certain other securities transactions (new article 55f SESTO)*

Article 55f SESTO stipulates some very important exemptions in connection with securities dealings, exempting from article 33e (1)(a) and 33f (1) SESTA:

- transactions in securities to implement a person's own decision (commonly referred to as "nobody can be his own insider"), in particular the acquisition of shares in a target company by the potential offeror in preparation of a public tender offer (*i.e.* pre-offer stake-building), provided that the offeror has no (other) inside information;
- transactions in securities by the Swiss Confederation, cantons, communities and the Swiss National Bank in connection with the performance of their public duties, provided they are not made for investment purposes.

Importantly, while the government expressly recognises (within limits) the principle of "nobody can be his own insider", regrettably another principle, *i.e.* that dealings between insiders do not constitute insider dealing, has been expressly rebutted by the Swiss government on page 11 of its report accompanying the revised SESTO.

### *iv) Statutory Safe Harbour: Certain permitted communication of Inside Information (new article 55g SESTO)*

Article 55g SESTO provides for the following important exemptions: Communication of inside information to another person will not be prohibited pursuant to article 33e (1) (b) SESTA, if:

(a) the recipient needs to have this information to perform its statutory or contractual duties; or

(b) the communication of such information is a prerequisite for the entry into a contract and the holder of inside information (i) cautions the recipient not to exploit the inside information, and (ii) puts on record the fact that inside information has been provided and that the recipient has received the cautionary statement.

In order to fall under the "contractual duties" exemption referred to under (a) above, the respective contract must have been entered into in compliance with applicable law. Accordingly, the exemption referred to under (a) covers, for example, the passing on of inside information to a mandated adviser in connection with a transaction or the giving of information to an employee's superior or to the board of directors of an issuer. In cases where the existence of statutory or contractual duties is not evident, it will be important to enter into appropriate written arrangements and adopt appropriate internal guidelines on dealing with insider information and trading.

The exemptions described above under (b) cover, for example, the provision of information in connection with pre-sounding activities and the granting of due diligence access to potential bidders in the context of an M&A transaction. In these cases it will be important that confidentiality and standstill agreements, leak contingency plans and other guidelines (*e.g.*, data room rules) are drafted appropriately and take into account the new legal requirements.

The safe harbour list in article 55g SESTO is expressed to be exhaustive. In particular, it does not give authority to the government or to another body (*e.g.*, FINMA) to grant further exemptions. This is unfortunate because it is almost impossible to cover in advance all activities which, on the one hand may fall within the scope of the prohibited market abuse behaviours covered by articles 33e and 33f SESTO, but which on the other hand may indeed constitute accepted market practice. To illustrate, according to article 53 of the SIX Listing Rules, an issuer is obliged to publish price sensitive information, but this case is not expressly mentioned in article 55g SESTO, nor is it entirely clear that a rule adopted by a stock exchange (even if approved by FINMA), will formally suffice to create an exemption from a prohibition set forth at a statutory level.

Finally, market participants will have to bear in mind that article 55a SESTO only provides a safe harbour for the passing of inside information covered by article 33e (i)

(b) SESTO; it does not dispense of the restrictions set forth in article 33e(i)(a) and (c) SESTO regarding the use of inside information and regarding the issuance or related recommendations.

### *v) Other (potentially) permitted behaviour (Accompanying Report of the Swiss Federal Council)*

In its accompanying report to the revised SESTO, the Swiss government has clarified that the following behaviours would not fall within the scope of articles 33e and 33f SESTO and, therefore, no express exemptions/safe harbours are necessary in such events:

- transactions in securities done with the knowledge of inside information, but where the knowledge of such information has no influence on the transaction, *e.g.*, the maintenance of an existing investment strategy which has been defined independently from the inside information, the exercise of rights of first refusal based on a shareholders agreement at the (pre-determined) purpose to maintain control; by contrast, the revocation of an order based on inside information would not be exempted;
- price management (*Kurspflege*), meaning providing liquidity to the market through the issuer or a third party mandated by the issuer in order to reduce large price-swings (as long as respective entries into the order book or executions send no misleading signals to market participants);
- market making to provide liquidity at the same time for both buy- and sell-orders and to narrow the difference between bid and ask price;
- the nearly simultaneous placing of buy- and sell-orders for the same securities on different market places for arbitrage purposes.

### *vi) Revised FINMA circular regarding Market Behaviour Rules*

In 2008, FINMA issued a circular on market conduct rules. The circular only applied to regulated securities dealers, banks and certain types of licensees under the Collective Investment Schemes Act.

With the entry into force of the new market abuse rules under the SESTA and SESTO which apply to all market participants, the FINMA circular requires a complete overhaul. A draft of the revised circular (FINMA Circular) together with an accompanying report have been published by FINMA for consultation on 27 March 2013. The consultation ended on 13 May 2013. The revised circular is expected to enter into force on 1 August 2013.

The first part (sections III-V) of the draft FINMA Circular provides for general rules on preventing insider information and market manipulation. They will apply to all natural persons and legal entities active in the financial market. Different to its predecessor (FINMA Circular 38/2008), the draft FINMA Circular contains only a short list of permitted behaviours. In turn, it introduces a relatively long but still not exhaustive list of prohibited practices, such as painting the tape, cornering, ramping, scalping, spoofing, wash trades, banging the close, etc. While this will provide helpful guidance to market participants, it should be noted that FINMA will reserve the right to assess transactions on a case-by-base basis, *i.e.* FINMA may deviate from the list if particular circumstances of a case so require.

In the second part (sections VI and VII), the draft FINMA Circular contains the following important additional rules, which, however, will only apply to FINMA supervised institutions:

- ***Primary markets, foreign securities and other secondary markets***: In order to assess the proper business conduct of an institution under prudential supervision, Section VI of the draft FINMA Circular prescribes that not only securities dealing on Swiss stock exchanges are relevant; it states that the new SESTA/SESTO rules on dealing with insider information and market manipulation will apply *mutatis mutandis* to (i) securities dealing in the primary market as well as to dealings on foreign stock exchanges, and (ii) business activities on other markets, including regarding commodities and foreign exchange.

- ***Market abuse related organizational requirements***: Section VII of the draft FINMA Circular sets forth organisational requirements to ensure proper market behaviour, taking into account recent experience and, where possible, international standards. These organisational requirements are no longer directed exclusively at securities dealers, but at all institutions under prudential supervision. The requirements relate to dealing with unlawful activities, including notification duties, Chinese walls, supervision of employees and other relevant persons, watch lists and restricted lists, duty to record, high frequency trading and review duties. These requirements will not be the same for every supervised institution, rather they will apply on an individual basis depending on its business activities, size and structure. The organisational measures necessary will have to be defined according to a risk assessment that needs to be conducted regularly.

From the above it follows that FINMA supervised institutions are required to review their organisation and guidelines to ensure compliance not only with the new SESTA/SESTO rules, but also the additional requirements set forth in sections VI and VII of the draft FINMA Circular.

### c) Who is responsible for enforcement of the administrative law market abuse rules and what are the sanctions in case of breach?

As stated in the introduction, enforcement of the administrative law market abuse rules against all market participants will be the responsibility of FINMA. For such purpose, FINMA will have quite far reaching investigative powers.

By contrast, FINMA will have limited means to sanction unlawful behaviour. Pursuant to article 34 SESTA, permitted sanctions will include the issuance of a declaratory decision, publication of such decision (so-called "naming and shaming») and confiscation of unlawful profits. Vis-à-vis FINMA supervised institutions, FINMA will retain further reaching sanction rights, including those set forth in the FINMAG and in article 35a SESTA (ban from profession, etc.).

## 3) Market Abuse under Criminal Law

The new Swiss rules on market abuse also introduce important changes under criminal law. On the one hand, the provisions on criminal insider dealing and market price manipulation have been transferred from the Criminal Code into the SESTA. On the other hand, and more importantly, the offence of insider dealing has been substantially expanded and stated more precisely, while in substance the offence of market price manipulation has remained unchanged. In addition, both offences are newly subjected to federal jurisdiction.

### a) What constitutes market abuse *under criminal law*?

Under the new rules, criminal market abuse comprises ***insider dealing*** (article 40 SESTA) on the one hand and ***market price manipulation*** (article 40a SESTA) on the other hand:

#### *i) Insider Dealing (new article 40 SESTA)*

According to the new article 40(1) SESTA, will be punished with of up to three years of prison or with a fine, any person, who as an officer or member of an executive or supervisory body of an issuer or a person controlling or controlled by the issuer, or as a person who due to its participation or activity is supposed to have access to inside information (all such persons being "primary insiders"), obtains for itself or for another person a financial advantage by:

(a) exploiting such inside information to acquire or dispose of securities admitted for trading on a stock exchange or on a similar platform in Switzerland or by using financial instruments derived from such securities; or

(b) communicating such information to another person; or

(c) exploiting such information to make a recommendation to another person to acquire, dispose of or use financial instruments regarding any securities covered by paragraph (a) above.

If the financial advantage resulting from an act covered by article 40(1) SESTA exceeds CHF 1 million, the sanction will be up to 5 years of prison or a fine (article 40(2) SESTA). This also means that such qualified cases will become predicate offences to money laundering.

While articles 40(1) and 40(2) SESTA deal with offences by primary insiders, article 40(3) SESTA stipulates that so-called "tippees", meaning persons who have received inside information from a primary insider pursuant to article 40(1) SESTA or through (another) crime or felony, will be punished with prison of up to one year or a fine if they obtain (for themselves or another person) a financial advantage by exploiting such inside information to acquire or dispose of securities admitted for trading on a stock exchange or on a similar platform in Switzerland or by using financial instruments derived from such securities.

Finally, pursuant to the new article 40(4) SESTA, those persons who are not a primary insider or a tippee pursuant to article 40 (1)-(3) SESTA will also be punished with a fine if they obtain (for themselves or another person) a financial advantage by exploiting inside information to acquire or dispose of securities admitted for trading on a stock exchange or on a similar platform in Switzerland or by using financial instruments derived from such securities.

From the above it follows that the Swiss criminal law provisions regarding insider dealing have been expanded in many respects. Namely, the term "primary insider" is much wider than before, the scope of prohibited actions has been broadened, and the potential sanctions are heavier. Moreover, even persons who accidentally become aware of inside information are now covered.

### *ii) Market Price Manipulation (new article 40a SESTA)*

Different to insider dealing, the criminal law rules on market price manipulation have essentially remained unchanged, other than transferring them from the Criminal Code to the SESTA. According to article 40a(1) SESTA, any person will be punished with of up to three years of prison or with a fine, who, with the aim to significantly influence the price of securities admitted for trading on a stock exchange or on a similar platform in Switzerland and thereby to achieve a financial advantage for itself or another person

(a) against better judgment disseminates wrong or misleading information, or

(b) effects sales and purchases of securities, which on both sides directly or indirectly are made for the account of the same person or persons that are affiliated for such purpose.

If the financial advantage exceeds CHF 1 million, the sanction will be up to 5 years of prison or a fine; *i.e.* such qualified cases of market price manipulation will also constitute predicate offences to money laundering.

As stated above, part (b) of the definition of market price manipulation under criminal law is much narrower than under administrative law in that it is limited to simulated transactions.

**b) Are there any statutory safe harbours or other (potential) exemptions?**

First of all, and different to market abuse under administrative law, any breach of the market abuse provisions under criminal law requires that the offender acted with intent (*Vorsatz*). Accordingly, an offender cannot be punished under article 40 (Insider Dealing) SESTA or article 40a (Market Price Manipulation) SESTA if he acted only negligently—but in such case he may nevertheless face sanctions under administrative law (see section 2 above) or civil liability. The same is true if the condition of "financial advantage" is not fulfilled.

Page 4 of the accompanying report of the Swiss government relating to the revised SESTO contains an important statement clarifying that by virtue of article 14 of the Swiss Criminal Code, the safe harbours and exemptions applicable to market abuse as set forth in the SESTO (see section 2.b above) also apply in relation to the market abuse provisions under criminal law.

Another important point to bear in mind is that because qualified cases of criminal insider dealing and market price manipulation by primary insiders constitute predicate offences to money laundering, financial intermediaries will be expected to monitor their clients to detect such insider dealing and market price manipulation. Consequently, persons qualifying as potential primary insiders (*e.g.*, executives of listed companies, auditors, lawyers, etc.) may need to be treated as high(er) risk clients who require more monitoring (see also note 39 of the draft FINMA Circular which stipulates a notification duty of FINMA supervised institutions vis-à-vis FINMA with respect to material breaches of articles 33e and 33f SESTA).

**c) Who is responsible for the enforcement of the criminal law market abuse rules?**

According to article 44 SESTA, criminal insider dealing and market price manipulation are subjected to federal jurisdiction, *i.e.* cantonal authorities are no longer competent, the prosecution will be the responsibility of the Office of the Federal Attorney General of Switzerland (*Bundesanwaltschaft*), and the court of first instance will be the Swiss Federal Criminal Court (*Bundesstrafgericht*).

#### 4) Conclusions

The revised Swiss administrative and criminal law rules regarding market abuse bring about a fundamental change of Swiss law and practice:

- A new administrative law regime has been introduced, which applies to all market participants, not only to securities dealers, banks and certain entities operating under a collective investment act license as in the past.
- In terms of substance, the scope of the Swiss market abuse rules, both under administrative and criminal law, has been significantly broadened.
- The revised rules call issuers, financial institutions, advisers and other affected persons to review and update their internal procedures and guidelines (*e.g.*, trading and communication guidelines, leak contingency plans, etc.) and standard forms (*e.g.*, confidentiality and standstill agreements) to ensure compliance with the new rules and to make appropriate use of the various safe harbours provided; in connection with this the revised FINMA circular on market behaviour, which is expected to come into force on 1 August 2013 and which will newly apply to all market participants, needs to be taken into account.
- Prudentially, FINMA supervised institutions will additionally have to take into account the special requirements applicable to them pursuant to the revised FINMA circular, including the additional market abuse related organizational requirements as well as the extended application of Swiss market behaviour rules in relation to primary markets, foreign securities and non-securities related markets.

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## Overhaul of Swiss Corporate Governance Regime for Listed Swiss Companies Following Approval of the Minder Initiative

Reference: CapLaw-2013-10

On 3 March 2013 a constitutional amendment was approved by the Swiss voters as proposed by the Minder say-on-pay initiative. By the end of May 2013, the Federal Office of Justice is expected to publish a draft implementing ordinance, which will be enacted on 1 January 2014. The implementing ordinance will overhaul the Swiss corporate governance regime for listed Swiss companies pending the enactment of a revised statute of law.

*By Ralph Malacrida*

### 1) Implementing Ordinance to Become Effective on 1 January 2014

On 3 March 2013, in a nation-wide vote the Swiss decided to amend the Constitution as proposed by the Minder constitutional initiative (Initiative). Pending the enactment of the revised law, the new constitutional principles will be implemented by a governmental ordinance, which must come into effect no later than 3 March 2014.

Based on comments of the Minister of Justice, the expected timetable for the issuance of the implementing ordinance is as follows:

- End of May 2013: the Federal Office of Justice will publish a first draft of the implementing ordinance.
- June–August 2013: public hearings on the draft implementing ordinance.
- September–November 2013: the Federal Office of Justice will review any comments made in the public hearings in detail and produce a final form of the implementing ordinance.
- 1 January 2014: the implementing ordinance will enter into force.

The key features of the new constitutional regime to be implemented by the Government's ordinance in a first step, and by the legislator through a bill of law in a second step, are set out below.

### 2) Say on Pay

#### a) Shareholders' Vote on Compensation

The aggregate compensation (cash and value of compensation in kind) of the board of directors, the senior management and the advisory board will be subject to approval by the general meeting of shareholders. The shareholders will have to vote on the total compensation of each of the board and the senior management as a group. No approval will be required for the compensation packages of individual directors or senior executives.

The Initiative is silent on the shareholders' approval conditions. In particular, the Initiative does not specify whether the approval shall be given in advance or whether it implies a ratification of payments earned in the past. In this regard, the implementing ordinance is expected to contain more detailed rules. In addition, the Initiative does not expressly state that the shareholders' vote shall be binding. This has prompted the question whether advisory votes should be permissible. At present, the majority view of legal writers is that advisory votes would not be in line with how the Initiative was presented when it was put to the national vote. However, proposals were made by legal commentators which in effect delegate the rule making power to the shareholders that would have to define the relevant rules in the articles of association.

### b) Amendments to Articles of Association

The Initiative requires that the articles of association contain rules for directors and senior managers on the amount of credits, loans, and retirement benefits. In addition, the articles must specify any incentive and participation plans, the numbers of positions of directors or senior managers outside the group as well as the duration of the senior managers' employment contracts.

Legal writers pointed out that the incorporation of retirement, incentive and participation plans in the articles of association would not be feasible because such plans are laid down in lengthy documents setting out detailed rules. If these rules were to be taken up in the articles of association, each change of a plan would require a notarized resolution of the general meeting of shareholders. Therefore, the implementing ordinance is expected to provide that the articles shall contain the basic parameters only.

## 3) Elections of Board Members

According to the Initiative the general meeting of shareholders shall elect the chairman of the board of directors, and individually each member of the board and the board's compensation committee, as well as the independent proxy.

## 4) Contracts with Members of the Board and Senior Management

The Initiative prohibits severance payments (golden handshakes) or similar payments, advance payments, special bonuses or awards for buying or selling companies, and any additional employment or consulting agreements involving another company in the group. In addition, the management of a company may not be delegated to a legal entity.

The Initiative does not define "severance payments", "similar payments" or "advance payments". The implementing ordinance is expected to clarify whether indirect severance payments taking the form of extended notice periods or payments as consideration for non-compete obligations will be permissible if they are based on valid grounds. As far as prohibited "advance payments" are concerned, the common view is that this involves payments under an employment contract that are made in advance as opposed to signing bonuses, which usually compensate the employee for losses suffered when leaving his former employer.

The scope of the new requirement that there be no additional employment or service agreements between a director or senior manager and any group company (other than the listed Swiss company) remains undefined. The purpose of this restriction is to prevent agreements between directors or senior managers and non-listed companies within the group to circumvent the shareholders' approval requirement, which only applies to listed Swiss companies. This purpose could be met by submitting compensation packages for approval to the shareholders on a consolidated basis, in which case a prohibition of multiple contracts would seem unnecessary. This point needs clarification by the governmental ordinance as well.

The Initiative does not elaborate on the effects the implementing law will have on existing agreements, including those containing contractual rights of senior management to receive golden handshakes, severance payments, etc. Some views are that existing contracts should not be affected because the Initiative does not enter into force retroactively, whereas others point out that the new law will apply to all existing agreements as of the time it becomes effective with the result that contractual provisions contravening the new law will be invalid.

### 5) Preparation and Conduct of General Meeting of Shareholders

#### a) Electronic Voting

The Initiative further prescribes that shareholders may vote electronically from a remote location. Legal commentators have pointed out that the introduction of electronic voting as envisaged by the Initiative should be optional because setting up the required voting systems could result in considerable costs so that the shareholders of each listed Swiss corporation should be able to weigh these costs against the possible upside of remote access to voting. Whether or not the shareholders should have a say on this will have to be addressed in the implementing ordinance.

#### b) Abolition of Corporate Proxies

The Initiative prohibits corporate proxies and representation of the shareholders by depositary banks. In consequence, proxies will have to be voted by the independent proxy who will have to be elected by the shareholders. Proxy cards, proxy statements and AGM notices will have to be amended accordingly.

#### c) New Agenda Items

Upon the entry into force of the new law, the (non-recurring) item to be put on the agenda involves a general revision of the articles of association to include rules on the amount of credits, loans and retirement benefits, incentive and participation plans for directors and senior managers, the number of positions directors or senior managers outside the group, as well as the duration of the senior managers' employment contracts.

Further, annual elections as a new standard item on the agenda of an AGM will involve the election of the chairman of the board of directors, and individually each member of the board and of the board's compensation committee as well as the independent proxy. The articles will have to be amended to that effect as well.

Finally, the approval of the total compensation for the board of directors, the senior management and the advisory board (if any) will have to be included as a standard item on the agenda of each AGM.

### d) Pension Funds

The Initiative states that pension funds must vote in the interests of their members and disclose how they voted. The current view is that only pension funds regulated by Switzerland's social security laws will fall within the scope of this requirement. It remains to be seen how the Government works out the details of how such pension funds must ensure that shares held by them are voted at a shareholders' meeting without imposing undue administrative burden.

### e) Criminal Sanctions

Contraventions of any requirements introduced by the Initiative as implemented by law shall be punishable by imprisonment for a term of up to three years and a fine of an amount up to the equivalent of six annual salaries. There is some controversy amongst legal scholars whether or not criminal sanctions may be introduced through the issuance of an ordinance by Government as opposed to a statute of law passed by the legislator.

### f) Next Steps

The Initiative's language is vague in many respects and requires implementing legislation. Therefore, the short term consequences of the Initiative remain uncertain pending publication of the draft implementing ordinance by the Federal Government at the end of May 2013. The definitive (long-term) consequences will become clear only after a bill of law will be drafted and adopted in Parliament. The new law will then be subject to a possible referendum, which may lead to a nation-wide vote again if this is requested by 50,000 Swiss citizens.

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# Revision of the Swiss Collective Investment Schemes Act—Consequences for Managers of Foreign Investment Funds

Reference: CapLaw-2013-11

On 13 February 2013 the Federal Council resolved to bring into force the revised Collective Investment Schemes Act (CISA) and its implementing Ordinance (CISO) as per 1 March 2013. The revised law has substantial impacts on the Swiss investment funds industry. Due to the altered regulatory concepts in terms of asset management regulation and distribution, particularly Swiss managers and advisors of foreign investment funds need to carefully analyze the revised CISA and potentially adapt their business models. This article highlights the new provisions relevant in this regards; it refects the legal position as of 6 June 2013.

*By Christian Koller*

## 1) Asset Management

### a) Supervision of Asset Managers

#### *i. General*

The revision of the CISA which was initiated by the Federal Council in summer 2011 aims at closing regulatory gaps and harmonizing Swiss law with international standards. In particular, Swiss regulation needed to be aligned with the European Directive 2011/61 on Alternative Investment Fund Managers (AIFM-D) in order to safeguard European market access for Swiss investment fund managers and products to the extent permissible under such directive.

As a result, the revised CISA demands that all managers of collective investment schemes (CIS) are licensed by the Swiss Financial Market Supervisory Authority (FINMA) unless they qualify for a specific exemption (article 2 (1) (a) and (c) CISA). According to the previous law, only managers of Swiss CIS were required to become licensed by FINMA and managers of foreign investment funds could under certain restrictive preconditions voluntarily submit to FINMA supervision.

New article 18a (1) CISA states that a manager's core responsibilities comprise portfolio management and risk management of one or several CIS. In addition, a manager may carry out administrative tasks for Swiss and foreign CIS, investment fund distribution as well as representation activities and notably perform discretionary portfolio management and individual investment advisory services (article 18a (2) and (3) CISA); this allows independent wealth managers and advisors to continuously manage investment funds. Article 24a CISO further entitles investment fund managers to carry out securities brokerage.

A manager of CIS must be organized as a corporate body, general partnership *(Kollektivgesellschaft)* or limited partnership *(Kommanditgesellschat)* (article 18 (1) (a) and (b) CISA). It may also be organized as a branch of a foreign asset manager of investment funds (article 18 (1) (c) CISA). An asset manager of CIS domiciled abroad but effectively managed in Switzerland or predominantly performing its business in or out of Switzerland must be organized pursuant to Swiss law and will be supervised by FINMA as a Swiss asset manager (article 29a (2) CISO).

***ii. Exemptions***

It follows from the above that asset management for collective investment schemes will be subject to increased regulation. Under the revised law, all managers will need to obtain a FINMA license unless (i) their investment vehicles are only open for investors belonging to the same group of companies as the manager itself (article 2 (2) (h) (3) CISA) or (ii) if they are exclusively marketed to *qualified investors* and fall under a *de-minimis* exemption. Please note that according to FINMA only asset managers of foreign but not of Swiss CIS may benefit from the exemptions under article 2 (2) (h) CISA (FINMA Newsletter 48 (2013) of 17 May 2013, p. 3).

The first *de-minimis* exemption applies if the assets of the managed CIS, including assets acquired through leveraged financing, amount to no more than CHF 100 million in total (articles 2 (2) (h) (1) CISA and 1b (1) (a) CISO). The second *de-minimis* exemption applies if the assets of the managed investment funds consist of non-leveraged collective investment vehicles which (underlying CIS) do not allow for redemptions within five years following first subscription and if such assets do not exceed CHF 500 million in total (article 2 (2) (h) (2) CISA). According to article 1b (3) CISO, a manager must notify FINMA within 10 days and file a license application with FINMA within 90 days after having exceeded a *de-minimis* threshold. Considering the stringent prerequisites for obtaining a license and the amount of information to be provided to FINMA, the time limit for filing an application is ambitious and requires managers to get adequately organized well ahead before approaching the thresholds.

As mentioned above, the *de-minimis* exemptions only apply in case of distribution to qualified investors within the meaning of the revised law (QI). Pursuant to article 10 (3) CISA, regulated financial intermediaries such as banks, securities dealers, fund management companies, asset managers of CIS, central banks (Regulated FI), regulated insurance companies as well as public and private institutions with professional treasury operations are deemed QI. Further, high-net-worth individuals are considered qualified if they make a respective written declaration (article 10 ($3^{bis}$) CISA) and confirm in writing that they hold assets of at least CHF 5,000,000 (article 6 (1) (b) CISO); this relatively high financial limit is reduced to CHF 500,000 if an individual may prove that she due to her personal education and professional or comparable experience in the financial sector is sufficiently knowledgeable to understand the risks inherent to the investment (article 6 (1) (a) CISO).

Last but not least, individuals are deemed QI if they have entered into a written discretionary asset management agreement with a Regulated FI or with an independent asset manager (Eligible IAM) (i) which is subject to Swiss anti-money laundering laws and (ii) adheres to the code of conduct employed by an industry body (such code of conduct being recognized by FINMA as a minimum standard) and (iii) whose discretionary management agreements comply with such recognized standards. Such individuals may opt for being treated as non-qualified investors by respective declaration.

#### *iii. Voluntary Submission to FINMA Supervision*

A Swiss asset manager of CIS falling under one of the above exemptions may not become licensed by FINMA unless this is a requirement under the law of the jurisdiction where the CIS is registered or distributed or if this is required by Swiss law (article 2 ($2^{bis}$) CISA and article 1c (1) (b) CISO); for instance in delegation situations, Swiss law may require an asset manager which is *per se* not qualified for a FINMA license to become prudentially supervised.

### b) Delegation of Functions

The revised law contains partly new provisions regarding the delegation of tasks by an asset manager of CIS to third parties. As before, delegation must be in the interests of efficient management and may only be made to properly qualified persons (article 18b (1) and (2) CISA). Further, neither risk nor portfolio management functions may be delegated to persons whose interests may conflict with those of investors of the CIS (article 26 CISO). Article 18b (3) CISA newly states that portfolio management functions may be delegated to regulated entities only. Considering the wording of this provision, one may assume that risk management functions may be delegated also to unregulated entities which would not be compatible with the AIFM-D.

The delegating asset manager is liable for a careful selection, instruction and supervision of the commissioned entity (article 145 (3) CISA). In order to fulfill such duties of care, an asset manager commissioning the services of a third party must retain those core competences in-house which allow for a diligent oversight of the service providers. This should be considered while evaluating outsourcing solutions, particularly with regards to portfolio and risk management, compliance as well as IT functions.

### c) License Requirements

#### *i. Financial Requirements*

As under the old law, asset managers of CIS shall have a minimum ***company capital*** of CHF 200,000 which needs to be paid-up in cash (article 19 (1) CISO); to the extent that they also carry out funds business activities (*Fondsgeschäft*) for foreign CIS, such minimum capital shall amount to CHF 500,000 (article 19 (2) CISO). Such enhanced capital requirement does therefore not generally apply if a Swiss entity manages a foreign CIS but only if an asset manager (in addition to asset and risk management functions) carries out administrative tasks for a foreign investment fund (such as bookkeeping, NAV reconciliations or share register administration). The components of the company capital are described in article 20 CISO. For stock corporations (*Aktiengesellschaft*) it comprises the share and participation capital and for limited liability companies (*GmbH*) the issued capital (*Stammkapital*).

Further, an asset managers' ***equity capital*** must amount to 0.02% of the assets of the managed CIS exceeding CHF 250 million but shall in any event not be less than 25% of the fixed costs as per the most recent financial statements; the maximum requirement shall be CHF 20 million (article 21 (1) CISO). The definition of equity capital has not been altered and (for stock and limited liability companies) comprises the company capital, statutory and other reserves, retained earnings, the net profit for the current financial year (after deduction of the estimated distributions), hidden reserves assigned to a separate account and designated as own funds and certain subordinated loans (which loans shall not exceed 50% of the equity capital in total) (article 22 CISO).

### *ii. Liability Coverage*

To cover potential professional liability risks, new article 21 (3) CISO requires an asset manager to either conclude a professional malpractice insurance in line with FINMA standards or to hold additional equity capital corresponding to 0.01% of the assets of the managed CIS.

### *iii. Major Authorization Conditions*

The conditions to be fulfilled by those persons responsible for governing and managing the asset manager of CIS as well as by the significant equity holders remain unchanged under the new law. In particular, the directors and officers must be of good repute, guarantee proper management and possess the requisite professional qualifications (article 14 (1) (a) CISA). This not only holds true for the management body but also for the board of directors: according to FINMA Newsletter 34 (2012) of 23 January 2012, the members of the board must have the relevant experience and knowledge as regards asset management and the accompanying risks. Further, the board as a body must have practical experience in risk management and compliance matters. As FINMA explicitly pointed out, the members of the board must continuously attend the company's business to fulfill the board's core tasks diligently and comprehensively. As is also promulgated in FINMA Newsletter 34 (2012), the board of directors shall consist of at least three members. The majority of the board must not carry out executive functions and at least one third should be independent from the significant shareholders (FINMA Newsletter 35 (2012) of 20 February 2012) and—according to current FINMA practice—the asset manager itself. Unchanged article 12 (1) CISO states that the management body of an asset manager of CIS must comprise at least two members.

In addition to such requirements for hierarchic (horizontal) segregations of functions between the board of directors and the management body, new article 12a (3) CISO imposes the duty to vertically separate the functions regarding risk management, internal control system and compliance from operational functions, in particular from the portfolio management. According to current FINMA practice, an asset manager must put in place an adequate deputy system with regards to its core tasks. Also in this respect, the principles regarding separations of functions must be adhered to which requirement would not be met if for instance a member of the compliance department deputizes the chief investment officer.

According to article 24 (1) CISO, asset managers of CIS must describe their scope of business in their articles of association, company or partnership agreements and organizational bylaws. In particular, such corporate documentation must reflect that the regulated entity has an appropriate risk management, internal control as well as compliance system in place (article 12a (1) CISO). A major task of every license preparation process therefore consists of analyzing the existing internal rules and regulations of an asset manager and bringing them in line with the regulatory requirements which also include the relevant guidelines and principles promulgated by the Swiss Funds Association as being the pertinent industry organization (article 14 (2) CISA).

## 2) Distribution

### a) General

The revised law entails a new distribution concept. Whereas under the old law only public distribution of collective investment schemes was subject to regulation, the revised CISA regulates distribution as such, irrespective of it being public or not. Considering the new definition of "distribution" and particularly its exceptions, the changes will be less fundamental than one might suspect. A new FINMA circular containing guidelines on the regulator's interpretation of the revised distribution rules is expected to be released later this year. It will replace FINMA Circular 2008/8 – "Public advertising collective investment schemes".

Systematically, one must distinguish between (i) marketing which is not considered distribution at all and therefore not within the regulator's scope and (ii) marketing which is considered distribution within the regulator's scope. In case of distribution within the meaning of the law, one must further differentiate between (iii) marketing to non-qualified investors and (iv) marketing to QI. In addition, the revised CISA establishes different legal consequences for marketing local or foreign CIS.

### b) Definition of Distribution

In principle, every offering of and advertisement for CIS in or out of Switzerland is considered distribution within the law (article 3 (1) CISA). However, this principle is broken by various exceptions. Pursuant to article 3 (1) and (2) CISA, no distribution is assumed if:

- units of CIS are sold or respective information is made available at the instance or initiative of the investor or in connection with advisory agreements as further defined in article 3 (3) CISO;
- marketing activities are addressed to Regulated FI or regulated insurance companies;
- units of CIS are sold or respective information is made available in connection with discretionary asset management agreements with either Regulated FI or Eligible IAM;
- Regulated FI publish prices, net asset values and tax data;
- employees are offered incentive compensation programs by way of CIS.

As mentioned above, to the extent that a marketing action is not considered distribution in the sense of article 3 (1) and (2) CISA, it is not subject to regulation at all.

### c) Distribution to Non-QI

If a marketing action falls within the legal definition of distribution, the law distinguishes between distribution to QI and non-QI. Distribution to ***non-QI*** entails the following consequences:

- The distributor needs a distribution license (13 (1) CISA).
- The distributor and the Swiss fund management company/Swiss CIS or the representative of a foreign CIS, respectively, must enter into a written distribution agreement (articles 30 (1) (c) and 30 (2) CISO).
- The distribution of foreign CIS needs prior FINMA approval. For that purpose, FINMA must be provided with the relevant documents relating to the CIS, such as the offering memorandum, the articles of association and the investment fund contract (article 120 (1) CISA).
- In case of distribution of foreign CIS, a Swiss paying agent and a Swiss representative need to be appointed (article 120 (2) (d) CISA).

#### d) Distribution to QI

As regards distribution to QI it should be noted that—given the exemptions pursuant to article 3 CISA—only distribution to institutional investors with professional treasury operations and to high-net-worth individuals (qualifying as QI) will be regulated. Distribution to other QI is not deemed "distribution» within the meaning of the law. Distribution to ***QI*** entails the following consequences:

– In principle, no distribution license is needed (article 13 (1) CISA, *e contrario*).

– If, however, foreign CIS are distributed in or out of Switzerland, the distributor must be licensed by FINMA or adequately supervised by its home country regulator (article 19 ($1^{bis}$) CISA); in this event there needs to be a written distribution agreement in place between the distributor and the representative of the foreign CIS (articles 30a and 131a (1) CISO).

– The distribution of foreign CIS does not need prior FINMA approval (article 120 (4) CISA).

– In case of distribution of foreign CIS, a Swiss paying agent and a Swiss representative need to be appointed (article 120 (4) CISA) which is a new requirement.

### 3) Ancillary New Obligations Concerning Management and Distribution

New articles 24 (3) CISA and 34a CISO require that persons involved in the distribution of CIS (in the sense of article 3 CISA) take written records with regards to the economic needs of the investors and the reasons for having recommended the purchase of a specific CIS to them. Please note that this provision shall enter into force on 1 January 2014.

According to article 20 (1) (c) CISA, FINMA regulated persons must safeguard a transparent reporting on the CIS they market, hold in custody or manage, reveal all direct and indirect costs and fees charged to the investors, and inform the investors in a complete, accurate and comprehensible way on all remunerations in connection with the distribution of the collective investment schemes.

### 4) Time Lines

Subject to the exemptions mentioned above regarding the definition of QI and records keeping duties, the new law and its implementing ordinance have entered into force on 1 March 2013.

The revised law contains various provisions regarding transition periods. Most notably, managers, distributors and representatives of foreign CIS which need to become licensed due to the expansion of the regulatory scope will have to notify FINMA thereof by 1 September 2013. Further, they need to fulfill the relevant license requirements by 1 March 2015 and until then file the respective application(s) with the regulator. Foreign collective investment schemes which are permitted for distribution to non-qualified investors in Switzerland will however need to fulfill the new approval requirements of article 120 (2) CISA by 1 March 2014. FINMA Newsletter 48 (2013) of 17 May 2013, p. 6 *et seq.,* provides guidance regarding the revised law's transition period regime.

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## New Rules on Offer Consideration in Voluntary Exchange Offers

Reference: CapLaw-2013-12

**On 1 May 2013, a new set of rules governing the obligation of the bidder to offer an all cash alternative in voluntary exchange offers has come into force. The most significant change pertains to the introduction of an obligation to offer a cash alternative if the bidder purchases target shares for cash during the twelve months preceding the announcement of the exchange offer.**

*By Dieter Dubs / Mariel Hoch*

Based on the experience gained since the rules regarding the obligation of the bidder to offer a cash alternative in certain situations of exchange offers have first been enacted in early 2009 (Article 43 (2) FINMA Stock Exchange ordinance (SESTO-FINMA) and the Takeover Board's (TOB) Circular No. 4), the TOB has acknowledged that, in certain respects, said rules are too burdensome on the bidders. The alleviations of the new regime are, however, outweighed by additional restrictions which are imposed on bidders of voluntary exchange offers (also called share-for-share offers).

The new rules on cash alternatives in voluntary exchange offers are contained in articles 9a and 9b of the revised Takeover Ordinance (TOO) and related provisions, replacing the current Circular No. 4 which has been abolished in its entirety as of 1 May 2013. These changes have been enacted concurrently with the abolishment of the right to pay control premia prior to the launch of an offer and certain other takeover law changes.

The new set of rules governs the type of consideration to be offered in voluntary exchange offers. It distinguishes between (i) exchange offers which include shares whose acquisition would entail a mandatory offer obligation (defined in article 9 (6) TOO as change-of-control-offers) and (ii) pure voluntary offers where (a) either the threshold for a mandatory offer is not triggered (partial offers) or (b) where the target company has a valid opting-out provision in its articles of association. In mandatory exchange offers, the obligation to always offer an all-cash alternative continues to apply unalteredly (article 43 (2) SESTO-FINMA).

Under the new rules, the following three time segments in relation to the offer should be distinguished:

– the twelve months preceding the announcement of a voluntary exchange offer (pre-announcement or publication of the offer prospectus);

– the period from the announcement until the completion of a voluntary exchange offer; and

– the period from the completion of the exchange offer until the expiration of the best price rule (*i.e.* six months following the end of the additional acceptance period).

Under the former regime, the ***first period*** was free of any triggers for an obligation to provide a cash alternative in voluntary exchange offers. Under the new rules, the bidder is obliged to offer an all-cash alternative to all recipients of a change-of-control offer if the bidder has purchased 10% or more of the target shares for cash during the twelve-month period preceding the announcement of the offer (article 9a (2) TOO). As this new restriction is limited to change-of-control offers, a bidder may purchase shares for cash in pure voluntary offers (*i.e.* partial offers and where the target disposes of an opting out) in this first period without triggering an obligation to offer a cash alternative.

In relation to the ***second period*** (*i.e.* from the announcement until the completion of the voluntary exchange offer), the new regime extends to all types of voluntary offers, including partial offers and offers where the target company disposes of a valid opting-out provision in its articles. In the event that the bidder (or any person acting in concert with the bidder such as the target company in case of a friendly offer) purchases any equity securities of the target for cash during this period, the bidder must extend an all cash alternative to all recipients of the exchange offer (article 9a (1) TOO).

It is only with respect to the ***third period*** (*i.e.* from the completion of the offer until the expiration of the best price) that the TOB has significantly relaxed the current rules. Unlike under the TOB's Circular No. 4 which has been abolished with the new regime coming into force, the bidder may purchase an unlimited number of target shares for cash once the offer has been completed. The value of such purchases is, however, governed by the best price rule which forbids purchases at a higher price than the offer price.

The new article 9b TOO stipulates a rule previously only contained in TOB's new abolished Circular No. 4: the cash alternative and the shares offered in exchange may differ in their respective values. According to the TOB's explanatory report on the revised rules of 10 April 2013, both types of considerations must, however, comply with the minimum price rule (*i.e.* a bidder may offer a premium on the share consideration while the all cash alternative may be limited to the minimum price). Although not explicitly mentioned in the explanatory report of the TOB, this reference to the floor setting of the minimum price rule must be limited to change-of-control offers and mandatory offers. In purely voluntary exchange offers, the minimum price rule does not apply (article 32 (4) SESTA) and may consequently not set a floor in relation to the obligation to offer a cash alternative.

With the exemption of the relaxation applying to the period following the completion of the exchange offer (third period), the new rules are increasingly restrictive on the bidder. Among other inconveniences, the financing costs for the bidder will significantly increase with these rules. The TOB justifies the changes with arguments of equal treatment of the recipients of the offer and therefore implies that cash is better than shares (the Merger Act implies, however, the contrary).

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## Update on Over-The-Counter (OTC) Derivatives Legislation in the US, in Switzerland and in the EU

Reference: CapLaw-2013-13

**In 2009, the G-20 leaders agreed that all standardized over-the-counter (OTC) derivative contracts should be traded on exchanges and cleared through central counterparties by the end of 2012. This article provides an update on the pending initiatives to regulate OTC derivatives in the US, in Switzerland and in the EU and gives a more detailed overview of the recently adopted European Regulation on OTC derivatives, central counterparties and trade repositories (EMIR).**

*by Thomas Werlen / Stefan Sulzer*

### 1) United States

In the US, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) was passed in July 2010 (see already CapLaw-2010-34, CapLaw-2010-47, CapLaw-2011-24 and CapLaw-2012-54). Since then, the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC) have finalized the majority of implementing rules to be developed under the Dodd-Frank Act. The US are now entering the implementation phase. On 13 August 2012, final rules on the definitions of the terms "swap" and "security-based swap" were published, triggering the effective date for many key rules under the Dodd-Frank Act. The final definitions and a number of final rules became effective on 12 October 2012.

The ***reporting obligations*** are phased-in by products and types of market participants: Swap Dealers and Major Market Participants must report interest rate and credit swaps since 12 October 2012 and equity swaps, foreign exchange swaps and other commodity swaps since January 2013. The rules also established a compliance date of 10 April 2013 for Non-swap Dealers and Non-major Swap Participants. However, on 9 April 2013, the CFTC issued a no-action letter providing non-financial Non-swap Dealers and non-financial Non-major Swap Participants with reporting relief with respect to (i) interest rate and credit swaps until 1 July 2013, (ii) equity, foreign exchange and other commodity swaps until 19 August 2013, and (iii) all other swap classes until 31 October 2013. Non-swap Dealers and Non-major Swap Participants that are financial entities must be in compliance with their reporting obligations with respect to interest rate and credit swaps since 10 April 2013. CFTC's no-action letter provides financial Non-swap Dealers and financial Non-major Swap Participants with reporting relief with respect to (i) equity, foreign exchange and other commodity swaps until 29 May 2013, and (iii) all other swap asset classes until 30 September 2013.

The ***clearing obligations*** will also be phased-in by products and type of market participants. On 28 September 2012, the CFTC has issued rules mandating clearing of four classes of interest rate swaps and two classes of index credit default swaps. Mandatory clearing for Swap Dealers and Major Swap Participants for these swaps began on 11 March 2013. Other parties will be required to clear these swaps beginning on 10 June 2013 and 9 September 2013. In addition, the application of the US securities laws to security-based swaps will become effective on 11 February 2014.

## 2. Switzerland

In Switzerland, there is no mandatory clearing or trade reporting regime in place for OTC derivatives transactions. However, Switzerland is committed to the implementation of the G-20 reforms on OTC derivatives. The Swiss Federal Council decided on 27 August 2012 that the existing Swiss regulation of financial market infrastructure needed to be amended to comply with the Financial Stability Board (FSB) recommendations and with the new standards developed by international standard setters for financial market infrastructure. The Federal Department of Finance has been instructed to prepare a draft consultation paper by spring 2013 and aims at coordinating its approach with legislative initiatives in the EU.

## 3. European Union

In the EU, OTC derivatives regulation is implemented through four legislative initiatives: (i) the European Market Infrastructure Regulation (EMIR); (ii) the Markets in Financial

Instruments Directive Revision (MiFID II) (this legislative initiative has not yet been finalized); (iii) the Short Selling and Credit Default Swap (CDS) Regulation (the new Regulation (EU) No 236/2012 came into force on 1 November 2012); and (iv) the Capital Requirements Directive IV (CRD IV—Basel III requirements) (this legislative initiative has not yet been finalized).

EMIR, which constitutes the main part of the EU OTC derivatives market reform, was adopted on 4 July 2012 and entered into force on 16 August 2012 (Regulation (EU) No. 648/2012) (see already CapLaw-2010-47 and CapLaw-2012-16). The main obligations under EMIR are: (i) central clearing for certain classes of OTC derivatives; (ii) application of risk mitigation techniques for non-centrally cleared OTC derivatives; (iii) reporting to trade repositories; (iv) application of organizational, conduct of business and prudential requirements for Central Counter Parties (CCPs); and (v) application of requirements for trade repositories, including the duty to make certain data available to the public and relevant authorities. The types of derivatives covered by EMIR are set out in Annex I of MiFID. EMIR applies to any entity established in the EU that has entered into a derivatives contract, and applies indirectly to non-EU counterparties trading with EU parties as well as to non-EU counterparties trading with each other, if a sufficient connection to the EU is established. EMIR identifies two main categories of counterparties to derivative transactions: (i) *financial counterparties*, which includes banks, insurers, investment firms, fund managers and pension schemes; and (ii) *non-financial counterparties*, which covers any counterparty that is not classified as a financial counterparty, including entities not involved in financial services.

As with any other EU Regulation, EMIR provisions are directly applicable, *i.e.,* are legally binding in all Member States without transposition into national law. However, many of the obligations under EMIR needed to be specified further via regulatory technical standards and became effective following the entry into force of these technical standards. On 19 December 2012, the European Commission adopted nine key Regulatory Technical Standards and Implementing Technical Standards, proposed by the European Securities and Markets Authority (ESMA), specifying obligations under EMIR. These Technical Standards have been published in the Official Journal on 21 December 2012 and 23 February 2013, respectively, and entered into force on 15 March 2013, which triggered the effective date for many key obligations under EMIR.

#### a) Clearing Obligations (derivatives cleared by CCPs)

Financial counterparties and non-financial counterparties must clear OTC derivative contracts that ESMA has determined are subject to a mandatory clearing obligation by an authorized or recognized CCP when they trade with each other or with third country (non-EU) entities that would be subject to the clearing obligation if established in the EU. The clearing obligation also applies to derivative transactions between entities incorporated outside of the EU that would be subject to the clearing obligation if they were incorporated in the EU, provided that the relevant transaction has a direct, substantial and foreseeable effect within the EU or where such an obligation is necessary or appropriate to prevent the evasion of any provisions of EMIR. ESMA has not yet published any details on what transactions have "direct, substantial and foreseeable effect within the EU".

***Central Counter Parties (CCPs).*** CCPs established in the EU and third country CCPs have six months, *i.e.,* until 15 September 2013, to submit their application for authorization or recognition under EMIR and the national competent authorities then have six months, *i.e.,* until 15 March 2014, to determine whether or not to authorize or recognize the CCP (Article 14 and 17 EMIR). To ensure that CCPs already active in the EU can continue to provide services during this transitional period, they may continue to operate, subject to any applicable national regimes, until they have been authorized or recognized under EMIR.

***Clearing Threshold.*** From 15 March 2013, non-financial counterparties have to calculate the clearing threshold and must notify the relevant national competent authority and ESMA if on any day, without taking into account any hedging transaction, the gross notional amount with respect to all OTC derivate transactions of the same asset class exceeds the following threshold with respect to such class: (i) EUR 1 billion for credit derivatives and equity derivatives; and (ii) EUR 3 billion for interest rate derivatives, foreign exchange derivatives, commodity derivatives and other OTC derivatives (Article 10 EMIR).

If a company reaches or exceeds the clearing threshold for one of the asset classes mentioned above, it is subject to the clearing obligation for all classes of OTC derivative transactions, and not just the class for which the clearing threshold has been reached or exceeded.

***Clearing Obligations.*** Clearing obligations will only apply, once CCPs have been authorized or recognized under EMIR. This step is necessary to ensure that CCPs are safe and sound. Where a national competent authority authorizes or recognizes a CCP to clear a class of OTC derivatives, it must immediately notify ESMA of that authorization or recognition. Within six months of receiving such notification, ESMA must submit draft regulatory technical standards on clearing obligations, specifying, among other things, the class of OTC derivatives that should be subject to the clearing obligation, and the date or dates from which the clearing obligation takes effect (Article 5 EMIR). In order to expedite the assessment of OTC derivatives to be cleared, national competent authorities had to notify ESMA of any existing classes of OTC derivatives cleared by CCPs in their jurisdiction by 15 April 2013.

Given the above, the first clearing obligations are not expected to arise until the first quarter of 2014.

**b) Risk Mitigation Techniques (derivatives not cleared by CCPs)**

Counterparties that enter into an OTC derivative transaction not cleared by a CCP must ensure that appropriate procedures and arrangements are in place to measure, monitor and mitigate operational risk and counterparty credit risk. Some of these risk mitigation techniques came into effect on 15 March 2013.

***Timely Confirmation Obligation.*** From 15 March 2013, financial counterparties and non-financial counterparties that enter into an OTC derivative transaction not cleared by a CCP must timely confirm the terms of the relevant OTC derivative transaction within deadlines specified in the applicable Technical Standard (Article 11(1)(a) EMIR). Confirmation means the documentation of the agreement of the counterparties to all the terms of an OTC derivative transaction. To comply with the confirmation requirement, the counterparties must, therefore, reach a legally binding agreement on all the terms of an OTC derivative transaction.

On 8 March 2013, the International Swaps and Derivatives Association, Inc. (ISDA) published the ISDA 2013 EMIR NFC Representation Protocol to enable parties to Covered Master Agreements to amend the terms of each such Covered Master Agreement to reflect the confirmation obligation under EMIR. The ISDA protocol and standard form wording is available under www2.isda.org/functional-areas/protocol-management/protocol/11.

***Daily Valuation.*** From 15 March 2013, financial counterparties and non-financial counterparties have to mark-to-market the value of outstanding derivative transactions on a daily basis (article 11(2) EMIR). Where market conditions prevent marking-to-market, reliable and prudent marking-to-model must be applied.

***Portfolio Reconciliation.*** EMIR requires portfolio reconciliation for financial counterparties. The frequency of portfolio reconciliation depends on how many OTC derivative transactions are outstanding between the counterparties. Daily reconciliations will be required when the number of outstanding OTC derivative transactions between counterparties is greater than 500. Weekly reconciliations will be required when the number of outstanding OTC derivative transactions is greater than 50 and less than 500. Quarterly reconciliations will be required when the number of OTC derivative transactions is less than 50.

***Portfolio Compression.*** Counterparties with 500 or more OTC derivative transactions outstanding (facing each other) which are not centrally cleared must have procedures in place to regularly, and at least twice a year, analyze the possibility to conduct a portfolio compression exercise in order to reduce their counterparty credit risk.

***Dispute Resolution.*** Counterparties must agree to detailed processes and procedures for the identification, recording and monitoring of disputes and their timely resolution. In addition, counterparties must notify the relevant competent authority where a dispute lasts longer than 15 business days and is for an amount or value higher than EUR 15 million.

The risk mitigation requirements regarding portfolio reconciliation, portfolio compression and dispute resolution (Article 11 (1) (b) EMIR) will apply from six months after the Technical Standards came into force, *i.e.,* from 15 September 2013.

***Margin Requirements.*** Financial counterparties and non-financial counterparties are required to have procedures for the timely, accurate and appropriately segregated exchange of collateral with respect to OTC derivative transactions. On 15 February 2013, the Basel Committee on Banking Supervision (BCBS) and the International Organization of Securities Commissions (IOSCO) published a consultative paper which represents a near-final proposal on margin requirements for non-centrally cleared derivatives for comment by 15 March 2013. Several features of this near-final proposal are intended to manage the liquidity impact of the margin requirements on financial market participants. It is proposed that variation margin will apply from 1 January 2015 and that initial margin requirements will be phased-in and would apply to the largest, most active and most systemically risky derivative market participants first with the threshold lowering gradually over a period of 4 years from 1 January 2015 up to 2019. The proposed requirements would allow for the introduction of a universal initial margin threshold of EUR 50 million.

The expected regulatory technical standards on margin requirements for uncleared OTC derivatives will follow the delivery of BCBS/IOSCO's final report.

***Capital Requirement.*** EMIR also requires financial counterparties to hold an appropriate and proportionate amount of capital to cover uncollateralized risks.

The precise level and exact type of collateral to be exchanged (margin requirements) and the level of capital required to manage the risk not covered by the appropriate exchange of collateral (capital requirement) will be specified by further regulatory technical standards. There is no timetable yet set to specify these requirements. It is unlikely that these requirements will enter into force before 2014.

### c) Reporting Obligations

Counterparties to all derivative transactions are required to report to a registered trade repository post-trade details of any derivative transaction they have concluded and of any modification or termination of the transaction. The details must be reported no later than the working day following the conclusion, modification or termination of the transaction. EMIR encourages counterparties to cooperate in the reporting process to avoid inconsistencies. EMIR specifically states that reports should be made without duplication and permits one counterparty, or a CCP, to report on behalf of both counterparties to the trade repository, or for the reporting duty to be delegated to a third party (*e.g.,* trading platform).

Trade repositories established in the EU and third-country trade repositories have six months, *i.e.,* until 15 September 2013, to apply to ESMA for registration or recognition under EMIR. To ensure that trade repositories already active in the EU can continue to provide services during this transitional period, they may continue to operate, subject to any applicable national regimes, until they have been registered or recognized under EMIR.

Reporting obligations for credit and interest rate derivatives will come into effect on 1 July 2013. For all other asset classes underlying derivatives, reporting will start on 1 January 2014, if the relevant trade repository has been registered before 1 October 2013, otherwise ninety days after registration or recognition of any such trade repository.

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

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