CAPLAW
SWISS CAPITAL MARKETS LAW

No. 5/2011

Securities

Takeover

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Proposed Revision of the Stock Exchange Act

Reference: CapLaw-2011-41

The Swiss Government has submitted to Parliament a draft bill to revise the Stock Exchange Act (SESTA). The proposals include, *inter alia,* far reaching changes to existing rules on insider trading and market manipulation, public takeovers and the disclosure of shareholdings for listed companies, and will be of significant practical relevance for Swiss and foreign issuers as well as other market participants.

By Philippe Weber

1) Introduction

On 31 August 2011, the Swiss Government has approved and submitted to Parliament a draft bill and accompanying message *(Botschaft)* regarding proposed changes to the SESTA and related legislation (the Proposal). The Proposal includes, *inter alia,* far reaching changes to Swiss insider and market manipulation law, takeover law and the rules on the disclosure of shareholdings for listed companies.

The Proposal is the result of a consultation process, which lasted over several years and on which we have reported in earlier CapLaw editions (see CapLaw-2009-27, CapLaw-2010-14 and CapLaw-2010-52). Due to the described consultation process the draft bill reflects a broad consensus. This is not uncommon for Swiss legislative proposals because every change of a federal statute is subject to the threat of public referendum and, hence, needs to be "referendum proof". Certain pieces of the Proposal, however, were introduced only after completion of the pre-parliamentary consultation process, *e.g.,* the proposal to extend the application of Swiss takeover and disclosure rules to foreign issuers with Swiss listings. Other parts, namely the proposal to abolish the "control premium" in the ambit of public tender offers, remain controversial. Accordingly, the Proposal may undergo certain amendments during the parliamentary approval process. However, on 21 October 2011 the legal committee of the Council of States *(Ständerat),* which is one of the two chambers of Parliament, already decided to recommend the draft bill without changes.

2) Proposed Changes relating to Insider Law and Market Manipulation

The Proposal contains important changes to existing rules on insider trading and market manipulation, including:

– The statutory rules on insider trading and market manipulation shall be moved from the Penal Code (PC) into the SESTA, and both offenses shall be prosecuted by the Office of the Attorney General of Switzerland and judged by the Federal Criminal Court, and no longer by the cantonal prosecution authorities;

– Supervisory market behavior rules on insider trading and market manipulation, which are currently only applicable to regulated financial intermediaries (banks, etc.) by virtue of a FINMA circular, shall be lifted to the level of statute (SESTA) and extended in scope to cover all market participants;

– The currently narrow definition of "primary insider" in the PC (*i.e.,* persons who, in the first instance, are capable of committing criminal insider trading, including by way of tippee), shall be broadened significantly. For example, under current law, as a rule shareholders or employees below management level *(e.g.,* research staff of a biotech company) do not fall within the definition;

– The scope of application shall additionally be extended or clarified in various respects, *e.g.,* the type of behaviors falling within the scope of market manipulation is broadened, the new rules would also apply to information concerning securities traded on platforms similar to stock exchanges *(börsenähnliche Einrichtung)* and ambiguities under current law with respect to mere buy or sell recommendations shall be eliminated;

– Material violations of insider trading and market manipulation rules shall be punished with up to 5 years imprisonment, which means that insider trading and market manipulation each become a preceding offense *(strafbare Vortat)* for money laundering.

The Proposal will call listed entities and other affected market participants to timely review their internal rules and procedures (for example, internal trading rules, both with respect to staff and trading in own shares, market making arrangements, communication policies, etc.) to ensure continued compliance with stricter insider and market manipulation regulation.

3) Proposed Changes relating to Takeover Law

The Proposal further contains some material changes to Swiss takeover law, including:

– The statutory rules on public tender offers shall no longer solely apply to companies incorporated *and* listed in Switzerland, but also to foreign incorporated companies with primary (equity) listing in Switzerland. In case of conflict between Swiss and foreign law provisions, Swiss law may be disapplied if the foreign law provides investors with a level of protection which is equivalent to that afforded under Swiss law;

– With the exception of purely voluntary tender offers, the ***minimum price*** for public takeover offers must be the higher of (1) the (60 days volume weighted average) trading price and (2) the highest price paid by the offeror during the past

12 months. Under present law, test (2) states "75% of the highest price paid", which enables an offeror to buy a controlling stake pre-launch at a control premium of up to 33% against the public offer price;

– If the Takeover Board (TOB) has sufficient evidence that a person has failed to make a mandatory tender offer the TOB shall be authorized, by way of injunction, to (i) suspend such person's voting and related rights, and (ii) prohibit that person (and persons acting in concert) to acquire any additional purchase or sale rights in respect of shares of the target company;

– The breach of the duty to submit a mandatory tender offer (provided such duty has been confirmed by a final decision of the TOB) shall become a criminal offense that can be punished with a fine of up to CHF 10,000,000;

– The minimum shareholding of target company shares which a shareholder needs to have in order to qualify as a party in proceedings before, and to appeal against decisions of, the TOB shall be raised from 2% to 3%.

As stated in the introduction, the above described proposals would have a significant impact on Swiss market practice and foreign issuers with Switzerland as primary place of listing of their shares. For example, foreign entities whose shares are listed on the SIX Swiss Exchange should consider a revision of their articles of association at their next annual general meeting in case they wish to include an "opting-up" or "opting-out" provision to exclude the Swiss tender offer rules as permitted under Swiss law (subject to certain exceptions).

Also, it remains to be seen whether the proposed abolishment of the "control premium" will pass the parliamentary hurdle; in its message, the Swiss Government argues that the Proposal will bring Swiss law in line with EU law and eliminate unequal treatment of shareholders. However, Swiss law recognizes that the principle of equal treatment is relative, *i.e.,* it may not necessarily be a breach of equal treatment if value is attributed to control, and several reputable jurisdictions outside of Europe as well as economic literature recognize the concept of "control premium". It may also be worth considering that the current law is not a competitive disadvantage (as seems to be the assumption) but rather provides potential IPO candidates with an alternative to other European listing places.

4) Proposed Changes relating to Disclosure of Shareholdings

Article 20 SESTA requires public disclosure by holders of qualified (buy or sale) equity positions (3, 5, 10, 15, 20, 25, 33 1/3, 50, and 66 2/3%) in listed companies. As it is the case under takeover law, the disclosure duties currently solely apply to equity positions in companies incorporated and listed in Switzerland.

In line with the proposed changes to takeover law, the Swiss Government proposes to extend the rules on the disclosure of shareholdings to foreign incorporated companies with primary listing in Switzerland. Different to the proposed new rules on takeover law, the Proposal provides for no exception for "conflicts of laws", *i.e.,* issuers do not have a right to "op-out" from disclosure rules by virtue of respective amendments in the articles of association. Accordingly, if the Proposal becomes law, foreign companies with primary listing in Switzerland will have to introduce appropriate procedures to ensure compliance with the new disclosure rules.

5) Next Steps

As stated above, the Proposal is the result of a lengthy consultation process. In a next step, the Proposal will have to be debated and approved by both chambers of the Swiss Parliament. Thereafter, the Swiss Government will have to await expiry of the 3 months referendum period before it can enact the revised law. It is expected that this process will be completed in the course of 2012. Given the importance of the proposed changes, however, affected market participants will have to take action before the expected entry into force of the new law.

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Swiss Capital Markets: Welcomed Fundamental Changes in Taxation of Debt Instruments Ahead

Reference: CapLaw-2011-42

Swiss banks will be forced to gradually increase their regulatory capital in the next years in order to implement Basel III. Motivated by the desire to facilitate the direct issuance of regulatory capital, Switzerland has recently abolished the issuance stamp tax on debt instruments. For the same reason, Switzerland is also considering implementing changes to the withholding tax system.

By Dieter Grünblatt / Stefan Oesterhelt

1) Introduction

a) Abolishment of Swiss Issuance Stamp Tax on Debt Instruments

Under a new law passed by Parliament on 30 September 2011, the Swiss issuance stamp tax on debt instruments shall be abolished entirely, and, in addition, the Swiss issuance stamp tax on the issuance of new stock upon conversion of (contingent) convertible bonds and similar debt instruments required to be issued by Swiss banks in accordance with the Banking Act shall also be abolished. Subject to a public referendum,

which is not expected to be demanded, the new law will probably enter into force in the first half of 2012.

b) Proposed Changes of Swiss Withholding Tax

In addition, under new law proposed by the Federal Council on 24 August 2011 on Swiss withholding taxation in relation to interest payments, the current deduction by the issuer at source (or the Swiss guarantor, as the case may be) will, if effected, be substituted for a deduction by Swiss paying agents, and, in principle, an exception for foreign investors will be provided for. It is expected that the proposed new law will be debated in Parliament early next year. If passed, entry into force will not be earlier than 1 January 2013 or 1 January 2014 as financial institutions will need time to implement the change. There exist, however, certain time constraints: In the amendment of the Banking Act passed on 30 September 2011 the Parliament refused to grant Swiss banks an exception for interest payments on (contingent) convertible bonds and similar debt instruments required to be issued under the amended Banking Act to meet increased regulatory capital requirements, and Swiss banks may face obstacles raising the required capital under the current withholding taxation system which subjects all interest payments by Swiss issuers to taxation at source.

c) Originally Part of "Too Big To Fail" Proposal

The new law has been occasioned by the "too big to fail" discussions and the respective amendment of the Banking Act. New tax legislation has been considered initially merely for banks of systemic relevance to allow them to tax-efficiently raise the required additional regulatory capital. Eventually, the scope of discussion became wider to also address certain tax disadvantages of the current system: The abolition of the issuance stamp tax should bring tax costs of raising debt in Switzerland in line with foreign markets and, thus, enhance the Swiss bond markets. The switch to the paying agent systems and the exception for foreign investors may, if ultimately suitably provided for in the new law, allow Swiss issuers (including banks forced by the amended Banking Act to raise additional capital) to directly raise debt outside Switzerland and operate finance and treasury centers in Switzerland.

2) The Current Law

a) Swiss Withholding Tax

Under the current law interest paid by a Swiss resident borrower is not in principle subject to Swiss withholding tax *(Verrechnungssteuer)* of 35%, unless the instrument under which interest is paid is classified as a "bond" *(Anleihensobligation),* a "debenture" *(Kassenobligation)* or a "deposit" *(Kundenguthaben)* for Swiss withholding tax purposes. Also, interest paid by a borrower resident outside Switzerland to a person resident in Switzerland is not currently subject to Swiss withholding tax. A bond issued

by a borrower resident outside Switzerland will be (re-)characterized as domestic issuance if such bond is guaranteed by the Swiss parent company and the proceeds from the issuance are used in Switzerland.

Under the current law, a fixed term instrument will be characterized as bond if it cannot be excluded pursuant to its terms that it is held at any time by more than 10 creditors that are not banks. If an instrument is classified as bond then the issuer or borrower must deduct 35% Swiss withholding tax on interest paid under the instrument (or the Swiss guarantor, if a (foreign) bond is (re-)classified as a Swiss domestic bond) irrespective of whether payment is made to an entity or individual inside or outside Switzerland for the entire term of the instrument. In addition, a Swiss securities issuance stamp tax *(Emissionsabgabe)* on the nominal amount at the rate of 0.12% per year will also apply to the issuer or borrower.

Swiss withholding tax currently is also triggered if a borrower has more than 20 lenders that are not banks under any type of fixed term debt instruments in the aggregate. In such a case the aggregate of loans and other fixed term interest bearing instruments is characterized as debenture and 35% Swiss withholding tax must be deducted by the issuer or borrower (or Swiss guarantor) on any interest payments. In addition, a Swiss securities issuance stamp tax at the rate of 0.06% per year will also apply if the term of such instrument is longer than 12 months.

Finally, 35% Swiss withholding tax is also required to be withheld by a borrower if instruments are characterized as taxable deposits. This is the case if under instruments that pursuant to their terms allow money to be deposited and withdrawn by the lender the borrower is a bank or has more than 100 account holders that are not banks in the aggregate. No Swiss securities issuance stamp tax will apply to deposits.

All these classifications remain unaffected by the proposed new law. Accordingly, under the new law withholding obligations should continue to arise only if an instrument falls within one of the aforementioned classes.

b) Bonds and debentures with real estate security remain subject to special income tax

On a related topic, interest payments on domestic bonds or debentures which are secured by real estate situated in Switzerland may be subject to an additional special real estate income tax levied at source at rates of 13% to 33% depending on the canton of the real estate. It is currently not considered to abolish this tax to the disadvantage of international mortgage backed bonds and similar debt.

3) The Proposed New Withholding Tax Law

As concerns the proposed new withholding tax legislation, it will, if effected, change the current system for interest paid on bonds and debentures fundamentally:

- it will replace the current withholding obligation of the issuer (or the Swiss guarantor, as the case may be) for a withholding obligation of Swiss paying agents;
- the scope of the withholding tax will be broadened and encompasses not only bonds and debenture of a Swiss issuer but also bonds and debenture issued by a foreign resident issuer if the interest is paid by a Swiss paying agent;
- interest payments to persons that are not individuals (*e.g.,* interest payments to companies) will be excluded from the withholding tax; and
- an affidavit procedure will be introduced allowing a Swiss paying agent to make an interest payment to a person resident outside Switzerland without withholding tax deduction if it is credibly established by way of affidavit that the person beneficially entitled to the interest payment is not a Swiss resident individual.

4) Function of Swiss Paying Agent

The paying agent, *i.e.,* any person who within the conduct of its business regularly or occasionally remits, transfers or credits interest in connection with bonds and debentures (as defined), or collects such interest for third parties, will be responsible for determination whether a payment constitutes a taxable interest payment and be liable for the tax to be deducted, in the worst case for the grossed-up tax amount. In addition, in the case of a bond with a predominant one-time interest payment, the paying agent will have to deduct withholding tax also in the case of a sale of such bond. This is fundamentally new, as accrued interest components are currently generally not subject to the withholding tax.

The paying agent will also be responsible for determining whether the exemption for foreign investors applies, *i.e.,* whether there is an affidavit credibly establishing that the person entitled to the interest payment is a person resident outside of Switzerland. If the paying agent has any doubt about the identity of the beneficial owner he will be required to withhold.

Accordingly, the tasks of Swiss paying agents are sensible and demanding. If the Swiss federal tax administration in an audit concludes that the Swiss paying agent did not withhold tax as required, the paying agent will be liable for tax not withheld, as mentioned earlier, in the worst case on the grossed-up amount. Financial institutions will not like this shift of responsibility and liability.

5) Comparison of Current Law and Proposed New Law

The diagram below compares the basic Swiss withholding tax situation under the current and the new law and includes the EU Savings Tax:

Issuer	Investor (beneficial owner)	Current Law		New Law	
			withheld by		withheld by
Domestic issuer	Domestic individual	WHT	Issuer	WHT	Swiss Paying Agent
	Domestic company	WHT		–	
	EU individual	WHT		Savings Tax	
	Foreign investor without affidavit	WHT		WHT	
	Foreign investor with affidavit	WHT		–	
	Foreign mutual fund	WHT		WHT	
Foreign issuer	Domestic individual	–	Swiss Paying Agent	WHT	Swiss Paying Agent
	EU individual	Savings Tax		Savings Tax	
	Other	–		–	
Foreign issuer with guarantee of Swiss parent company (assuming proceeds not used in Switzerland under current issuances)	Domestic individual	–	Swiss Paying Agent	WHT	Swiss Paying Agent
	Domestic company	–		–	
	EU individual	Savings Tax		Savings Tax	
	Foreign investor without affidavit	–		WHT*	
	Foreign investor with affidavit	–		–	

WHT: 35% Swiss Withholding Tax
Savings Tax: Savings Tax based on Swiss-EU Savings Tax Agreement

*Grandfathering rule for bonds issued by a foreign issuer with guarantee of Swiss parent company (provided proceeds are used outside Switzerland).

Bonds issued by a foreign subsidiary which are guaranteed by the Swiss parent company will classify as Swiss domestic bonds under the proposed new law and not anymore as foreign bonds (even if proceeds are used outside Switzerland). The same rule applies for bonds issued by a foreign banking branch of a Swiss bank. This change is proposed to discourage foreign bond issuances by Swiss issuers (or in other

words: to enhance the Swiss bond market). However, a grandfathering rule applies for bonds of this type issued before entry into force of the new law; they will continue to be treated as foreign bonds.

6) Does the Proposed New Law Achieve the Goals?

a) Foreign Investors

A key question with regard to the proposed new law will be whether Swiss issuers (and Swiss paying agents) can avoid the Swiss withholding tax obligations (and the affidavit requirements) on bonds issued to foreign investors entirely in the first instance by simply ensuring that the interest is directly paid into foreign bank and clearing systems for distribution to the investors, noting that any flows back into Switzerland would of course be subject to the tax on the level of the Swiss paying agent making or crediting a payment to a Swiss individual.

If in such a scenario the issuer would indeed not be considered the relevant Swiss paying agent, the goal of facilitating foreign bond issuances would be achieved but the control character of the tax emphasized by the Council be severely undermined as payments by foreign paying agents to Swiss individuals holding bank accounts outside of Switzerland will be out of control. It would in such circumstances be more appropriate to abolish withholding obligations with regard to payments to foreign persons in general.

b) Payments to Foreign Mutual Funds

The proposed new law will not achieve the goal of facilitating investments in Swiss bonds through foreign mutual funds as they will not be considered foreign investors under the new law even if they can show that all of their investors are foreign resident persons. Parliament should reconsider this point.

c) Dual System

There is no change proposed for deposits. Deposits will remain subject to taxation at source. Hence, there will be a dual tax withholding system in place in Switzerland for debt instruments: a withholding system on the paying level for bonds and debentures and a withholding system on the level of the borrower for deposits (banks and other financial institutions and all other entities with more than 100 account holders).

In addition, under the current system distributions on equity instruments to the extent not made out of tax-free repayable capital (capital reserves and par value) will also continue to be subject to 35% withholding at source on the level of the Swiss corporations making the distribution.

This dual system will add complexity and the question is why the Federal Council did not propose a complete switch to the paying agent system. A main reason for not doing so may be that Switzerland can introduce an exception for foreign debt holders and abandon residual interest withholding tax entitlements under double tax treaties without losing a lot of tax money as foreign investors normally anyway do not hold debt subject to Swiss tax withholding, whereas this may not be true for deposits and equity instruments.

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Takeover Board Opts-Out from Opting-Out

Reference: CapLaw-2011-43

Opting-out from the mandatory offer has been in again since the Takeover Board (TOB) rendered its decisions in the matters CI Com SA and COS Computer Software AG in 2010. 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 or the TOB? On 22 September 2011, the TOB issued a decision in the matter LEM Holding SA, reinforcing the TOB's position taken in the CI Com SA decision, pursuant to which the TOB should not be involved in the realm of corporate law as long as shareholders make an educated decision when voting in favor of the opting-out.

By Frank Gerhard

This contribution analyses the LEM Holding SA decision (decision 0490/01 of the TOB dated 22 September 2011) and its position within the line of other TOB precedents, and includes a matrix of the competences of the TOB when faced with an opting-out clause, in particular in connection with a corporate transaction.

1) Mandatory Offer at the Disposal of Shareholders

All European Union countries as well as Switzerland have introduced the mandatory offer obligation in case a shareholder (or a group of shareholders acting in concert) exceeds a certain threshold (in Switzerland: 33.33%) of the voting rights in a listed company. However, opting-out from the mandatory offer obligation 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" 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) Stock Exchange Act (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. The possibility to opt-out from the mandatory offer regime is a concession by the Swiss Parliament made in connection with the controversial introduction of the mandatory offer in the SESTA in 1995. Interestingly, the Dispatch *(Botschaft)* of the Federal Council on the draft SESTA originally provided for a mere voluntary application of the SESTA (opting-in). A general mandatory offer obligation was only added to the SESTA by the Parliament debates with an aim to protect minority shareholders from a change of control that would be against their interests by offering them the opportunity to tender their shares at a certain minimum price (and thereby participate in the potential control premium paid by the acquirer).

2) The Statutory Regime on Opting-Out

The SESTA distinguishes between electing to opt-out ***before*** and electing to opt-out ***after*** the listing of the shares of the issuer on a stock exchange (article 22 (2), respectively article 22 (3) SESTA). If the election is made ***after*** the listing, article 22 (3) SESTA requires that such election shall not prejudice the interests of the shareholders within the meaning of article 706 of the Code of Obligations (CO). Accordingly, shareholders may not elect to opt-out from the mandatory offer obligation after listing if such election would (i) withdraw or restrict the rights of the shareholders in breach of the law or the articles of incorporation of the company (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 the unequal treatment or disadvantaging of the 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). Unless the articles of incorporation provide otherwise, an election to opt-out requires an amendment of the articles of incorporation by a notarized resolution of the shareholders' meeting adopted by at least a simple majority of the votes represented (article 703 CO).

Despite the straightforward wording of the applicable legal provisions, electing to opt-out ***after*** listing turned out to be an exercise with perilous obstacles that a practitioner reading article 22 (3) SESTA and article 706 CO would not have expected. In addition, so far, decisions to opt-out have only kept the TOB and the FINMA (respectively its predecessor, the Federal Banking Commission (FBC)), and not the civil courts, busy. Why? The decision to opt-out is taken by shareholders' resolution and, therefore, any review of such decision should lie within the competence of the civil courts (article 706 CO), as long as such resolution is not taken while a public takeover offer is pending on the company (article 22 (1) SESTA *e contrario*). It is worthwhile to take a step back here in order to understand why the introduction of the opting-out became so perilous and why the FBC, respectively the TOB (and not the civil courts) were the stumbling block.

3) The Development of the Opting-Out Doctrine

The first relevant intervention by the TOB was made in the ***ESEC Holding AG/Unaxis Holding AG*** case in 2000 (Recommendation 0018/02 of the TOB dated 6 June 2000). The applicant Unaxis Holding AG (Unaxis) held 13.28% of the voting rights in ESEC Holding AG (ESEC) and was about to exercise a call option which would have resulted in a participation of 76.66% of the voting rights in ESEC. Before such exercise, Unaxis wanted a confirmation from the TOB that it was not subject to the mandatory offer obligation, provided ESEC had introduced an opting-out clause in its articles of incorporation. Both Unaxis and ESEC were of the opinion that it was in the interest of ESEC to remain a listed company. In addition, because ESEC wanted to restrict the rights of its shareholders in the most limited way possible, the board proposed to limit the duration of the opting-out to 14 months and its applicability to one specific acquirer (Unaxis), and to have such provision vetted by the independent shareholders in a special meeting. The TOB dealt with the question with a certain distant view, because the election to opt-out was basically a corporate law issue: the shareholders could vote on the introduction of the opting-out clause after having been fully informed about the circumstances and consequences of such a resolution. The only legal ground on which the TOB could look into the request was if it involved a preliminary question on an issue that fell within the TOB's competence. 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, it had to be determined whether the shareholders' resolution was valid, and, in order to make such determination, whether the opting-out provision was compatible with the general standard 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 the special meeting of independent 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 ensure that the substance of the resolution was correct. The TOB had thereby indirectly expressed the opinion that electing to opt-out should in fact be a matter to be dealt with by the civil courts. Yet, the FBC (Decision of the FBC dated 23 June 2000) overturned the TOB's decision and held that an the opting-out provision which is only in favor of a specific acquirer or in view of a specific transaction is not permissible under Swiss law, whether or not the provision was approved by a special majority of the minority 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) SESTA, applicable to all acquirers and not limited in duration on the other hand, leave no room for such a formally selective cherry picking. *Tertium non datur.* Against this background,

the FBC did not evaluate in depth whether ESEC's opting-out provision complied with article 706 (2) CO as provided in article 22 (3) SESTA. *Ite missa est.* One could only speculate whether the opting-out practice that followed this decision would have been different had the board of ESEC, instead of trying to limit the effect of the opting-out provision, proposed a generic and unrestricted opting-out provision, *i.e.,* not limited to a specific transaction and a specific acquirer.

In the 2004 case ***Adval Tech Holding AG***, the TOB expanded the practice initiated by the FBC and held that an opting-out provision 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—not formally (as in ESEC), but as to its substance—and therefore violated the principle of equal treatment of the shareholders because it did not benefit all shareholders (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). The TOB then completed its autonomous interpretation of the opting-out provision and stated that 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 still selective in substance. At this stage, neither the FBC nor the TOB had really addressed the general principles of corporate law as set forth in article 706 CO in their 2000 and 2004 cases. Positively, this practice prevented the introduction of an opting-out clause in connection with a specific transaction because such clause would per se violate the principle of equal treatment of the shareholders. Indeed, who in today's world is actually planning more than five years ahead? Further, negatively, this practice forced potential acquirers to obtain advance rulings from the TOB any time a target had an opting-out clause in place since any such acquirer would want to make sure that such opting-out clause was not selective and, therefore, enforceable.

Only in 2010, the TOB rendered two decisions that adopted a more relaxed approach as to examine the opting-out clause and setting the ground work for the changes resulting from its LEM Holding SA decision. In the ***CI Com SA*** decision (Decision 0437/01 of the TOB 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 substance, *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 and the majority shareholder was readily identifiable by the other shareholders; under these circumstances, it is not necessary to extend the protection granted by article 706 CO and article 706a CO, which entitle any shareholder to challenge the shareholders' resolution within two months, through a mechanism embedded in the takeover law. Thus, the intervention of the TOB is superfluous.

In the ***COS Computer Systems AG*** decision of 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 introducing an opting-out clause into its articles of incorporation to its shareholders in 2009—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 no acquirer was around at the time the clause was introduced, and 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 substance, 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, but should (and could) be valid if the limitation on the rights of shareholders is based on valid reasons and any disadvantages or unequal treatment incurred by the shareholders are justified by an overwhelming corporate interest (see article 706 (2) (2) and (3) CO). *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.

4) The LEM Holding SA Decision

a) The Facts

Werner O. Weber has been a shareholder of LEM Holding SA since 2001. Over time, he steadily increased his stake in the company. He crossed the 5% threshold in October 2001, 10% in April 2004, 15% and 20% in October 2007 and the 25% threshold in June 2008. At a board meeting on 29 January 2010, he unveiled his intention

to cross, together with another shareholder (and a board member), Ueli Wampfler, the 33.33% voting rights threshold. Weber also mentioned his intention to introduce an opting-out clause into the company's articles of incorporation so that there would be no obligation to launch a mandatory offer. In connection with the 2010 AGM, Werner O. Weber requested the introduction of an opting-out clause into the company's articles of incorporation to be put on the agenda of the shareholders' meeting (according to Swiss law, any shareholder holding shares of at least CHF 1 mio in nominal value or 10% of the share capital can put items on the AGM agenda). After the board of LEM Holding SA in its invitation to the AGM scheduled for 25 June 2010 recommended to reject Weber's proposal, it reiterated its view during the AGM, putting forward that an opting-out would not be in the interest of the shareholders. At the 2010 AGM, the shareholders resolved to introduce the opting-out clause into the articles of incorporation with 71% of the votes represented. 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 Werner O. Weber).

On 26 May 2011, a year after the 2010 AGM, Werner O. Weber announced that he is acting in concert with Ueli Wampfler, board member of LEM Holding SA. On 7 June 2011, the shareholder group Weber/Wampfler announced a stake corresponding to 32.38% of the voting rights. On 31 August 2011, they requested a confirmation from the TOB as to the validity of the previously introduced opting-out clause.

b) Takeover Board Considerations and Ruling

The TOB qualified the opting-out clause as being selective in substance, since it had been introduced less than 5 years prior to its application and benefited mainly one specific shareholder, Werner O. Weber, who owned 27.8% at the time of its introduction and had requested its introduction. However, the TOB did not address the question of whether the clause was in compliance with the corporate principles enshrined in article 706 CO as it did in the COS Computer Systems AG case. Instead, the TOB came to the following conclusions:

– At the time of the 2010 AGM, the shareholders knew that Werner O. Weber held a significant stake in the company (27.8%) and that he was the author of the request to introduce the opting-out into the articles of incorporation of the company.

– Although Werner O. Weber did not disclose his intention to continue stake building and thereby to exceed the threshold triggering the mandatory offer obligation, it was implicitly clear that he would benefit from the opting-out clause and would be relieved from launching a mandatory offer should he ever exceed the threshold.

– Further, the board of directors recommended that the shareholders reject the proposal and explained the potential effects of such a clause on the company and its shareholders during the shareholders' meeting.

Hence, according to the TOB, the shareholders took an educated decision when voting in favor of the opting-out clause since the information provided to them was complete and transparent. In fact, without counting the votes of Werner O. 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), which would have made the intervention of the TOB superfluous. Hence, extending the two months deadline provided by corporate law in article 706 CO and article 706a CO would be contrary to the need of the security of transactions.

c) Position of the Board of Directors of LEM Holding SA

In its opinion rendered to the TOB, the board of directors of LEM Holding AG (Ueli Wampfler abstained from participating as he was conflicted) was of the view that the opting-out clause had been validly passed by the shareholders' meeting for following reasons:

– Sufficient information had been disclosed, and the potential effects of such opting out clause had been explained, at the shareholders' meeting.

– The opting-out clause had been approved by a large majority of the shareholders represented at the general meeting (71% of the votes represented voted in favor of the opting out) despite the negative recommendation of the board of directors.

– The company had benefited from a stable shareholder base in the past years ("important factor contributing to the continuous, independent and successful development of LEM Holding SA in the best interest of LEM and its shareholders").

d) Comments

The LEM Holding SA decision merges both the CI Com SA and the COS Computer Software AG practice (in both the CI Com SA and the COS Computer Software AG cases, the opting-out clauses were however not introduced in view of a specific acquirer or a specific transaction): the TOB will no longer review opting-out clauses, even if they are selective in substance, as long as the shareholders approved such clause after having been fully informed of the circumstances and the consequences of such approval. The only reason for the TOB to intervene in the realm of corporate law is to protect the shareholders against the introduction of an opting-out clause approved without being sufficiently informed about the perspective of a specific transaction. If such undisclosed transaction is then completed (by such a majority shareholder) more

than two months after the shareholders approved the opting-out clause, the (minority) shareholders are no longer able to challenge the approval of such clause. We welcome this approach whereby the TOB "opts out" from reviewing questions of corporate law when this can be done by the civil courts. This is in line with the approach the TOB has taken in other similar situations. For instance, in response to prevailing criticism of the TOB's scrutiny of share buyback's compliance with the 10% limitation set out in article 659 CO (Decision 408/01 of the TOB dated 2 April 2009 in the matter Partners Group Holding AG, c.2), it issued a new Circular No. 1 dated 26 February 2010 on share buybacks which no longer includes this practice (which practice was actually already dropped in the ***Transocean Ltd.*** case (Decision 435/02 of the TOB dated 24 February 2010 in the matter Transocean Ltd., c. 1/2)).

We will never know whether LEM Holding SA's opting-out clause would have been upheld if a shareholder had challenged the shareholders' resolution—however, we doubt it. Indeed, according to article 706 (2) (2) and (3) CO, the opting-out clause must be based on valid reasons *(matériellement fondée), i.e.,* must contribute to reaching the goal set by the company or must not aim at favoring the interests of select shareholders, and must be proportionate *(proportionnée), i.e.,* must be adequate and necessary in order to pursue the interest of the company and the advantages to the company must supersede the interests of the minority shareholders (Decision 0437/01 of the TOB dated 4 March 2010 in the matter CI Com SA, c. 2.1, confirmed in Decision 0490/01 of the TOB dated 22 September 2011 in the matter LEM Holding SA, c. 2.1). Maybe Werner O. Weber was just lucky that no shareholder challenged the shareholders' resolution… Indeed, we believe that Werner O. Weber's move was rather bold: his request to introduce such a clause was driven by purely private interests, namely in order to enable him to continue his stake building without triggering the takeover offer obligation, or, even bolder, to thereafter sell his stake to an acquirer without forcing the latter to launch a mandatory offer, hence allowing Werner O. Weber to collect the entire premium for the control over the target. From the perspective of Werner O. Weber, this is a maximization of the value of its own shareholdings to the detriment of all other shareholders (which, under Swiss law, is not *per se* prohibited as a shareholder owes no duty of loyalty to the company or the other shareholders). The board of directors was aware of this and recommended to vote against the opting-out clause. As a side note, the report of the board to the TOB issued more than one year later is rather sibylline as it formally opines only on the validity of the resolution by the shareholders' meeting (which is easy to state if the formalities for the AGM have been complied with, the resolution has not been challenged and the resolution is not null and void from the outset), but makes certain contradictory statements in the introduction, such as, on the one hand, that the stable shareholder structure of the company during the past years has been an important factor contributing to the continuous, independent and successful development of the company, in the best interest of the company and its shareholders, but then, on the other hand, the board wishes the acquisition of shares of the company to

remain an attractive investment for institutional and private investors and, therefore, will continue to pay great attention to equal treatment of the company's shareholders.

Moreover, considering that the board of directors provided comprehensive information as to the opting-out and other factual circumstances only at the AGM (and not prior to, *e.g.,* in the invitation to the AGM), the TOB's conclusion (and key requirement to distant itself from any further scrutiny of the opting-out clause), being that the shareholders have made an educated decision, may come as a slight surprise. In future, we would not be surprised to see more elaborated invitations to the shareholders' meeting resolving upon an opting-out, possibly accompanied by additional means of communications, to ensure educated approvals.

5) The Opting-Out Matrix, in particular in Connection with Corporate Transactions

The new picture after the LEM Holding SA decision permits the practitioner to address three different situations:

a) The shareholders made an educated decision when voting in favor of the opting-out clause

If the shareholders were clearly informed about the circumstances and the consequences of the introduction of the opting-out clause, the TOB will not meddle in the realm of the civil courts; the shareholders can fend for themselves using the means offered by general corporate law. This is true even if the opting-out is selective in substance. This is for example the case when a major shareholder that is 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) or the shareholders may infer from the circumstances that such a major shareholder could exceed the mandatory offer threshold and thereby benefit 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). So far, no such cases have been brought to civil courts. However, we believe that the introduction of an opting-out clause to pursue private interests only of a given shareholder will not pass the test of article 706 CO. Indeed, the 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.

The assessment could, however, be different if the opting-out clause is introduced by a target in connection with a 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. Another situation that could justify the introduction of an opting-out clause arises when an acquirer issues ***new*** securities as consideration for an acquisition, and such issue of securities would result in a person being obliged to make a mandatory offer. For instance, the UK Takeover Panel under the City Code on Takeovers and Mergers (the Code) will normally waive the obligation to launch a takeover offer in such a situation, provided that the shareholders who are independent of the transaction pass a resolution approving the waiver. This is known as the so called whitewash procedure. By providing for the whitewash procedure, the Code gives the independent shareholders of the company, subject to certain safeguards, the opportunity to assess the commercial merits of a transaction against the possibility of giving away control of the company. This procedure was, by the way, exactly the procedure chosen by ESEC in 2000.

b) The opting-out clause is not selective because it is not introduced in favor of a specific acquirer or a specific transaction, or was adopted more than five years ago

In such cases, the clause will be valid from a takeover law point of view. Indeed, the only reason for the TOB to intervene in the realm of corporate law is to protect the shareholders against the introduction of an opting-out clause if approved not being privy to the perspective of a specific transaction. In other words, the company would have misrepresented or dissimulated the situation to the shareholders. This is not the case if the company introduces the opting-out clause without having a specific acquirer or a specific transaction in mind, and no shareholder can be identified that would immediately or potentially benefit from the clause. We also believe that a company introducing an opting-out clause in connection with a strategic review (see the COS Computer Software AG case) would fall into this category. These cases are not problematic, and are not relevant in practice—except that they may lead to an application to the TOB for a declarative opinion confirming the validity of the opting-out clause from a takeover law perspective—because it is unlikely that a transaction calling for an opting-out clause would be planned more than five years in advance.

c) The opting-out clause is selective in substance because it is introduced in favor of a specific acquirer or a specific transaction, and the shareholders' meeting had not taken an educated decision when approving the opting-out clause

This is the situation where the TOB functions as the long arm of the civil courts and would, under certain conditions only, reach into the realm of corporate law by scruti-

nizing an opting-out clause after the lapse of the two month period provided by article 706a CO. Indeed, if such undisclosed transaction is completed (by such a majority shareholder) more than two months after the shareholders approve the opting-out clause, the (minority) shareholders are no longer able to challenge the approval of such clause. The TOB would therefore review the opting-out and would consider its validity (from a takeover law point of view) if any limitations on the rights of the shareholders are based on valid reasons and any disadvantages incurred by the shareholders are justified by an overwhelming corporate interest (see article 706 (2) (2) and (3) CO). The TOB voluntarily placed itself in this situation in the COS Computer Services AG matter because it held that it was not clear whether the relevant opting-out clause was selective in substance since the clause was adopted in connection with a strategic review process started in 2007, which led to a change of control in 2010.

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Proceedings Regarding the Duty to Launch an Offer: Exemption From the (Potential) Target's Duty to Issue and Publish a Board Report

Reference: CapLaw-2011-44

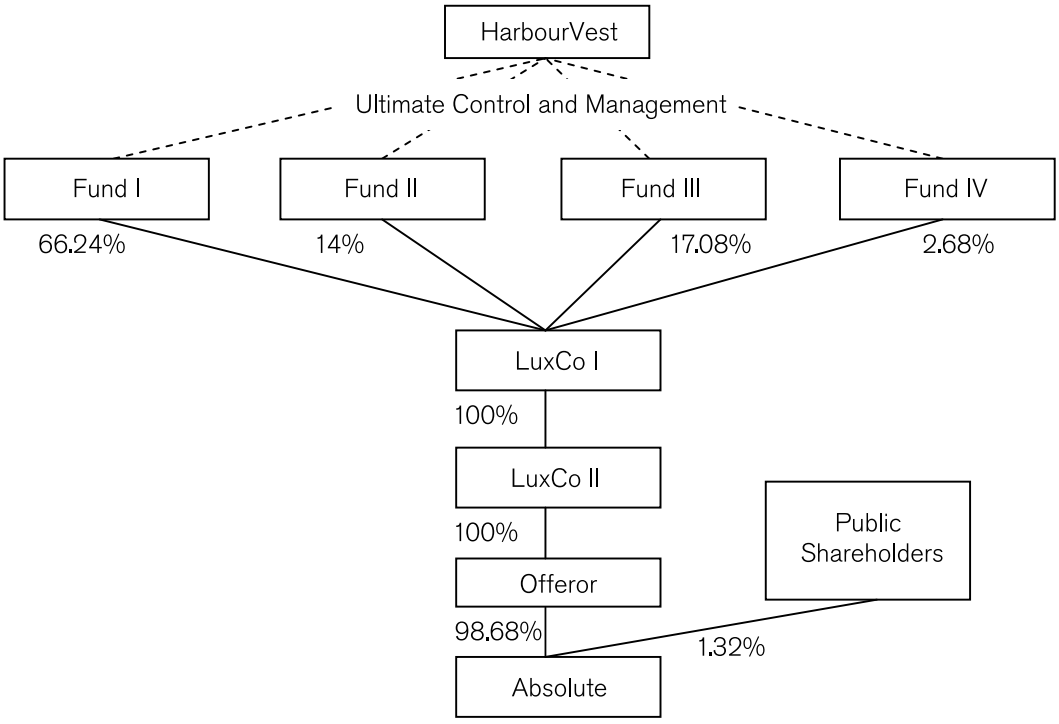
In a recent order the Takeover Board had to rule on whether the sale of a minority stake in a parent of the controlling shareholder of a listed company triggered the duty to launch a tender offer, if such sale leads to a change in the group of shareholders controlling the listed company. The decision is of particular interest with regard to the duty of the (potential) target company to issue and publish a board report. In the case at hand the Takeover Board granted an exemption from such duty upon the petitioners' request.

By Severin Roelli / Christian Leuenberger

1) Facts

a) Ownership Structure in Absolute

On 13 September 2011 HarbourVest Acquisition GmbH (Offeror), a special purpose vehicle ultimately controlled and managed by HarbourVest Partners, LLC (HarbourVest), settled its public tender offer for all publicly held shares of Absolute Private Equity Ltd (Absolute), an investment company listed at SIX Swiss Exchange, and thereby acquired ownership of 98.68% of all shares and voting rights in Absolute. Upon settlement, the ownership structure in Absolute and the Offeror was as follows:



As set forth in the above chart, upon settlement 98.68% of all voting rights in Absolute were held by entities all of which were ultimately controlled and managed by HarbourVest (HarbourVest Group).

On 14 September 2011 the Offeror filed a squeeze-out claim pursuant to article 33 Stock Exchange Act (SESTA) for cancellation of the 1.32% of the voting rights which remained held in public.

b) The Contemplated Transaction

HarbourVest and the Abu Dhabi Investment Authority (ADIA) considered an indirect investment of ADIA into Absolute by having a special purpose vehicle wholly-owned by ADIA (SPV), purchase 8-9% of the shares and voting rights in LuxCo I from Fund I (Contemplated Transaction). The Contemplated Transaction included the conclusion of a shareholders' agreement among all shareholders in LuxCo I, including the SPV. While such shareholders' agreement would, among other, contain sale restrictions and a duty for the SPV to vote its shares in LuxCo I according to the instructions of HarbourVest, it would not grant the SPV any veto rights or other means of additional influence.

On 5 October 2011—and in line with the market practice to request an order from the Takeover Board (TOB) prior to entering into such transactions—the Offeror and the SPV (Petitioners) filed a request for a TOB order (i) declaring that the Contemplated Transaction did not trigger the obligation to make an offer pursuant to article 32 SESTA—neither for the group of entities acting in concert nor for any individual entity—or (ii), *eventualiter,* granting an exemption from such obligation. The request was complemented by the procedural motion that the TOB abstain from requesting a report of Absolute's board of directors pursuant to article 61 (3) Takeover Ordinance (TOO).

In its order of 11 October 2011 the TOB held that the Contemplated Transaction did, indeed, not trigger the obligation to make an offer and that Absolute was granted an exemption from the duty to issue and publish a board report.

2) Considerations of the Takeover Board in Respect of the Duty to Launch an Offer

The TOB confirmed its well-established practice that in case of a change in the controlling group of shareholders—be it due to the accession of a new member to the group, a transfer of shares between group members or a modification to the terms of a shareholders' agreement among the group members—it must be assessed whether such change leads to a significantly different situation within the group and, thereby, creates a new group. If it does, the minority shareholders must be granted the option to exit the company as this could tantamount to a change of control.

With respect to the Contemplated Transaction the TOB, not surprisingly, followed the Petitioners' line of argumentation and held, firstly, that the HarbourVest Group was holding more than 33 1/3% of the voting rights in Absolute and that the Contemplated Transaction would not change this fact. In particular, under the Contemplated Transaction the SPV would not cross the threshold pursuant to article 32 SESTA, but would only hold a stake of 8-9% in LuxCo I. As such stake would not allow the SPV to control LuxCo I the latter's stake in Absolute could not be allocated to the SPV either.

The TOB held, secondly, that the Contemplated Transaction would lead to a change in the controlling group of shareholders, as ADIA and the SPV would accede to the HarbourVest Group. However, as outlined by the Petitioners, such accession would not lead to a significantly different situation within the group which—from the minority shareholders' perspective—would tantamount to a change in control. In particular, the Contemplated Transaction would not change the fact that HarbourVest controlled LuxCo I and, therefore, also the latter's subsidiaries including Absolute. Thus, from the perspective of Absolute's minority shareholders there was no change at all.

3) Considerations of the Takeover Board in Respect of Absolute's Duty to Issue and Publish a Board Report

The TOB held that in proceedings regarding the duty to make an offer article 61 (1) TOO requires the board of directors of the (potential) target company to issue a board report which outlines the considerations leading the board to support or oppose the request. In addition, the board report must disclose conflicts of interests of the board members, if any, and the measures taken to address them. The board report serves two purposes: on the one hand, it provides qualified shareholders (*i.e.,* shareholders holding at least 2% of the voting rights in the (potential) target company) with the information required for taking a fully informed decision whether or not to file an appeal pursuant to article 58 TOO and, on the other hand, it serves as a mean to indirectly observe the non-qualified minority shareholders' right to be heard.

While the law does not explicitly provide for an exemption from the duty to publish a board report, the TOB followed the Petitioners' line of argument with respect to their procedural motion and granted an exemption based on article 4 TOO which allows the TOB to waive compliance with provisions of the TOO, provided justified overriding interests.

In its assessment of the interests at stake with respect to the Contemplated Transaction, the TOB followed the Petitioners who had argued, firstly, that under the circumstances a board report could not serve the purpose of providing qualified shareholders with the information required for a decision regarding the exercise of their right to appeal, simply because it is impossible that there are any qualified minority shareholders in Absolute as long as the Offeror holds more than 98% of the voting rights in Absolute. Even though it is not mentioned in the TOB's order, the following background information is noteworthy: while under the circumstances (namely, the pending squeeze-out claim) it seemed very unlikely that the Offeror would dispose of any of its voting rights in Absolute, the Petitioners had offered to provide the TOB, and the TOB then requested, a certificate of the depository bank confirming that the shares amounting to 98.68% of all voting rights in Absolute will be blocked for a certain time. This served as a mean to dispel any doubts of the TOB that there could be a qualified minority shareholder at the relevant point in time nonetheless.

The TOB further followed the Petitioners who had argued, secondly, that under the circumstances the non-qualified minority shareholders had no reasonable interest in the proceedings regarding the duty to make an offer: a squeeze-out claim pursuant to article 33 SESTA had been filed with the competent court and, because the material requirements for a cancellation of shares were obviously met, the minority shareholders were going to lose their Absolute shares in the near future. In this situation, the interest of the minority shareholders is reasonably limited to receiving the consideration pursuant to article 33 SESTA. This interest of the minority shareholders is safeguarded

in the squeeze-out proceedings, namely by the minority shareholders' choice to accede to those proceedings.

As a result, the TOB concluded that in view of the interests at stake with respect to the Contemplated Transaction, Absolute can be granted an exemption from the duty to publish a board report.

TOB Order 0493/01 dated 11 October 2011

The authors are Swiss counsel to the HarbourVest Group in connection with the take-over offer for Absolute and all matters related thereto.

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Swiss Solvency Test

Reference: CapLaw-2011-45

The Swiss Solvency Test has been a topic of hot debate in the Swiss insurance sector for the past few years. It complements the Solvency I regime by introducing a dynamic, model based test to determine the required regulatory capital to transact insurance business. This article provides an overview of the key characteristics of the Swiss Solvency Test and sheds light on some of the most controversial issues in its implementation.

By Adrian Brügger

1) Legal Grounds of the Swiss Solvency Test

The new Swiss solvency regime for insurance companies, the Swiss Solvency Test (SST), was devised as an answer to an increased volatility in the capital markets, in particular the stock prices, after 2001/2002. However, as the existing solvency regime—now described as *Solvency I*—was not abolished, with the introduction of the SST the insurance companies have to fulfil both solvency requirements.

The major goal behind the introduction of the SST as a principle based model was to capture both asset risks and liability risks based on economic principles (i) by using a market consistent valuation of assets and liabilities and (ii) by introducing a model and scenario based calculation of the required capital levels.

The SST is set out according to the following legal grounds:

a) Art. 9 (2) Insurance Supervision Act (ISA).

   Art. 9 ISA mentions that insurance companies have to ensure a sufficient capital basis and gives the Swiss Financial Market Authority (FINMA) the mandate to devise the specific methods for the calculation and definition of the solvency requirements.

b) In execution of the mandate set out in art. 9 ISA, the Federal Council has established the Insurance Supervision Ordinance (ISO).

   Art. 41-53 ISO, Annex 2 *Expected Shortfall* and Annex 3 *Market consistent valuation* form the legal grounds for the SST. Art. 41-53 give a high-level description of the SST as a solvency regime. Annex 2 ISO and Annex 3 ISO provide some details as to the calculation of the "expected shortfall" and as to requirements for the market consistent valuation of assets and liabilities.

c) The FINMA Circular 2008/44 SST (CI 08/44) lays out the SST in greater detail, although the core mechanism of the SST, *i.e.,* the models and the scenarios, is only described in a qualitative way. Further to the SST's characteristic as a principle based model, most quantitative parameters have been left to an informed discussion and an expert reasoning process among FINMA and the insurance companies, which opens the possibility for some flexibility in the setting of the parameters but also leaves an important basis for the entire insurance industry at the discretion of FINMA.

2) Description of the SST

As under Solvency I, the SST requires that the available capital *(Risk Bearing Capital* or *RBC)* must be higher than the required capital *(Target Capital* or *TC).* The SST is based upon a new type of balance sheet, the market consistent balance sheet (cf. N 16 CI 08/44), in which all asset and liability categories are appraised at their market price (Mark to Market) or—in case no reliable market prices are available—at their estimated price (Mark to Model).

The Risk Bearing Capital is made up of (i) the Core Capital and (ii) the Supplementary Capital. The Core Capital *does not* correspond to what is legally known as capital or paid-in capital (art. 621 and art. 632 Code of Obligations (CO)) but is defined as the difference between the assets and liabilities of the market consistent balance sheet (N 11 and 48-49 CI 08/44). The Supplementary Capital is comprised of Hybrid Capital as per art. 39 ISO. The SST recognises Supplementary Capital up to a total limit of 100% of the Core Capital for the *Upper Supplementary Capital* (undated hybrids, cf.

art. 49 (1) ISO) and up to 50% of the Core Capital for the *Lower Supplementary Capital* (dated hybrids, cf. art. 49 (2) ISO). These limits are not additional, the total Supplementary Capital may only correspond to 100% of the Core Capital.

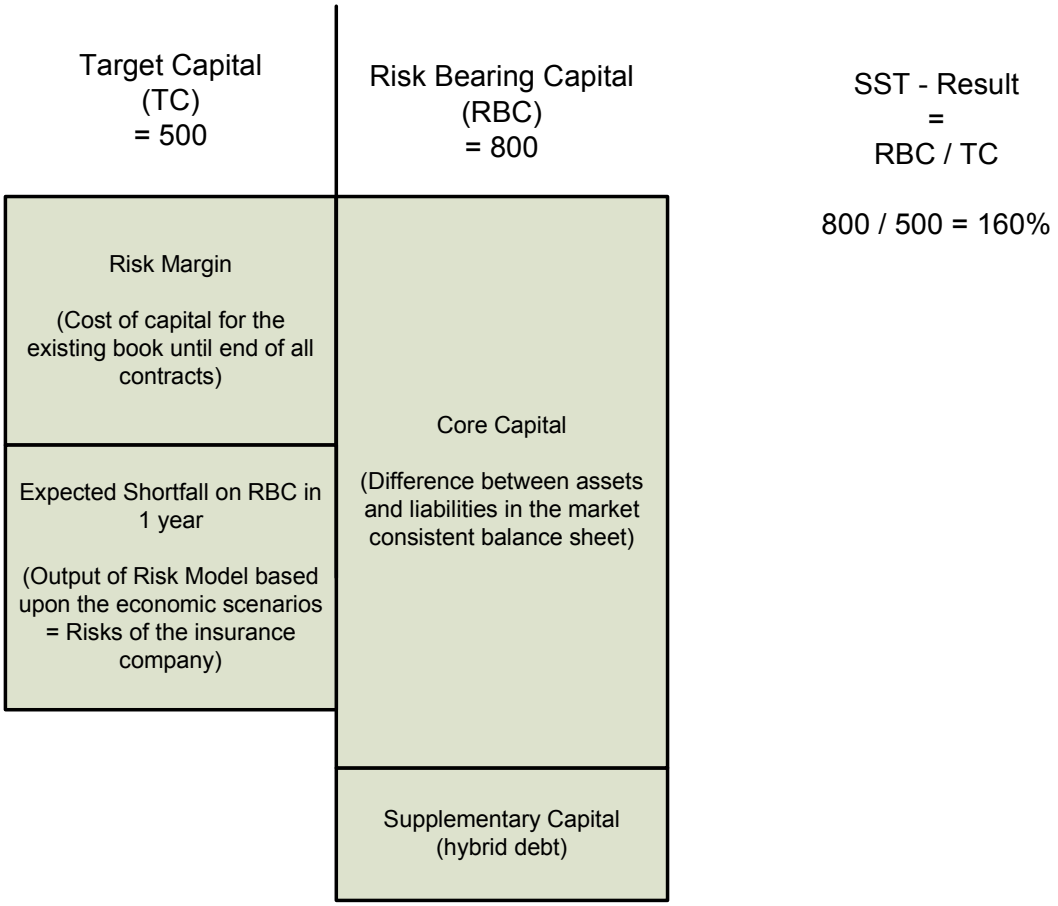
As a simplification, one can assume that the vast majority of the assets of an insurance company can be valued at market value, whereas the insurance liabilities will have no market value and therefore must be valued according to a model.

The Target Capital is the sum of the Risk Margin and the Expected Shortfall of the change in Risk Bearing Capital in one year at the confidence level of 99%. The Risk Margin reflects the cost of capital to cover the risk-bearing capital to be made available for covering insurance liabilities over their lifetime, *i.e.,* the costs of capital if the insurance company were to cease taking new business (N 57 CI 08/44).

The Expected Shortfall (ES) is a measure of a possible maximum loss in one year and depends on the risks of the insurance company, whereby these risks are measured by an economic risk model and economic scenarios. The input parameters of the model, the risk model itself and also the economic scenarios are typically specific to each insurance company, which makes a comparison of SST results across insurance companies quite difficult. The risk model and the economic scenarios for the one year SST period are the core of the SST regime and Circular 08/44 contains a list of the risks to be taken into account such as insurance risks, market risks, credit risks and other types of risks such as operational risks and model risks (N 79–69 CI 08/44). FINMA provides a standard model and insurance companies are strongly encouraged to develop an internal risk model, which must be approved by FINMA (groups and reinsurance companies are required to develop an internal risk model, life insurers must develop an internal model depending on their business mix). Most insurance companies have developed an internal risk model.

The insurance companies calculate the model outcome for various scenarios (some are given by FINMA and the insurance companies are required to develop own scenarios); this model outcome gives the expected loss or gain of the insurance operation over the next year. The insurance companies have to run a sufficiently large number of scenarios and compute the average of the worst 1% model outcomes. This average of the worst results is the ES and is then taken over into the SST calculation.

The SST can be summarized as follows:



3) Main Differences Compared to the Solvency I Requirements

Solvency I uses a simple calculation of the required capital for life insurers based upon a certain percentage of the technical reserves (*i.e.,* the reserves built-up by the insurance company to ensure payment of its insurance liabilities) and some percentage of sums at risk, meaning that Solvency I only considers the liabilities and not the asset side of the balance sheet. Solvency I does therefore not measure the risks on the asset side of the balance sheet, however the insurance regulation limits insurance companies in their asset selection and asset allocation, thereby limiting the maximum risks on the asset side of the balance sheet.

Local Solvency I is based upon the statutory accounting (*i.e.,* the Code of Obligations) values and Group Solvency I is based on IFRS figures, whereas the SST establishes an own valuation of the assets and liabilities. Indeed, the SST introduces a new specific balance sheet, which means that the insurance companies now have an additional balance sheet to manage (SST in addition to CO and IFRS).

4) Issues and Legal Analysis

a) Valuation of Insurance Liabilities

To correctly value the insurance liabilities, the insurance company has to aggregate all contractual liabilities and compute the present value of such future liabilities by using the discount rate for risk-free assets. Art. 3 of Annex 3 ISO describes the calculation method and sets out that the insurance company has to use the risk-free interest curve (Swiss government bonds).

However, the relevance of the interest rate curve of Swiss government bonds is not equal for all maturities. While Swiss government bonds with maturities up to ten years have a broad market and therefore show a relevant market price for the risk-free interest rate, longer maturities only have a very narrow market with a low liquidity. The prices found in such thin-liquidity environments do not reflect the long term risk-free interest rate as is demonstrated by the fact that a more liquid instrument, the swap market, gives a different interest rate for long term risk-free assets. Specifically, the swap rate curve shows a higher long term risk-free interest rate than the illiquid interest rate curve of the Swiss government long term maturities instruments. A higher discount rate as implied by the swap rate curve would mean that the present value of the future insurance liabilities is lower than by using the illiquid and non-representative Swiss government interest rate curve. A lower present value of the insurance liabilities in turn would mean that the Risk Bearing Capital is higher, because the Core Capital as a component of the RBC is defined as the difference between the assets and the liabilities of the market consistent balance sheet. Obviously, FINMA claims that one has to use the Swiss government interest rate curve for all maturities, whereas the insurance companies would prefer to use the swap rate curve, because of the higher liquidity of the market and the fact that capital market instruments used for hedging purposes are available based on swap rates only.

Art. 3 (2) Annex 3 ISO forms the basis for FINMA's claim that insurance companies have to use the Swiss government interest rate curve for all maturities.

However, the interpretation of the clause leads to a different result: A grammatical analysis of art. 3 (2) Annex 3 ISO does not clearly state that the SST must be based on the Swiss government interest rate in any case. Art. 3 (2) Annex 3 ISO states as a basis that one has to use the risk-free interest rate, followed by an example or precision in brackets, that as a principle the insurance company has to use the Swiss government interest rate curve as a proxy for the risk free rate.

If the grammatical interpretation does not lead to an entirely clear result or if the result of the grammatical interpretation leads to a result that is not compatible with the stated objectives of the regulation, the clause has to be interpreted. In particular, the clause should be interpreted according to the purpose of the regulation (cf. Decisions of the

Federal Supreme Court of Switzerland: BGE 112 Ib 465 E. 3b/BGE 108 II 149 E. 2). Such a teleological interpretation leads to the conclusion that the use of the swap rate curve is within the realm of the existing regulation.

The purpose of art. 3 (2) Annex 3 ISO, and indeed the purpose of the entire SST regime, is to establish and use a market consistent valuation of both assets and liabilities. The use of an interest rate curve that does not reflect relevant prices—because the underlying instruments trade in a low liquidity environment—is not in accordance with the objectives of the SST framework. Thanks to a more liquid market even for longer maturities, the swap rate curve does much better reflect the true long term risk-free interest rate curve and better fulfils the objectives and goals of the SST regulation. Therefore, the use of the swap rate curve better fulfils the objectives of the insurance supervision laws than the government rate and therefore has to be allowed in the computation of the SST.

b) Complexity of the SST Risk Model: Example of the Real Estate Model

The Swiss insurance industry is heavily invested in real estate in Switzerland (both commercial and residential) and such investments have proved to be very successful in the last ten years.

Under the SST regime, the insurance companies have to capture the risks of the real estate assets in a specific partial risk model. Initially, the real estate risk models submitted by the insurance companies foresaw that the price of real estate depends on the interest rate level: As a bond loses value if the interest rates increase and gains value if the interest rates decline, the Swiss Insurance Association is of the opinion that the price of real estate is influenced—at least to a certain degree—by movements in the interest rates (Minhea Constantinescu, *What is the 'duration' of Swiss direct real estate?,* Swiss Finance Institute, University of Zurich, 2010, published in the Journal of Property Investment and Finance, vol 28, no. 3; Alain Chaney, Martin Hoesli, *The Interest Rate Sensitivity of Real Estate,* Swiss Finance Institute, Research Paper Series No 10–13). In other words, real estate shows a certain interest rate sensitivity and therefore has a *duration* (the *modified duration* is a measure of the interest rate sensitivity) which would allow real estate assets to be used for duration matching, meaning that the duration of assets and liabilities would be matched as closely as possible. The duration matching of assets and liabilities is highly desirable as this effectively hedges out the effects of interest rate changes.

However, FINMA is of the opinion that real estate has no interest rate sensitivity at all and that past efforts to demonstrate such interest rate sensitivity have failed. In FINMA's opinion, real estate prices simply do not depend in any way on interest rate levels. Swiss insurance companies therefore can no longer use real estate for their du-

ration matching (real estate still is part of the asset allocation and significantly contributes to the asset returns).

Due to the lack of concrete description of the risk models in the ISO, there is no realistic way to legally challenge FINMA's opinion regarding real estate.

On 4 August 2011, FINMA published a new information *(Mitteilung)* on the acceptance criteria of internal real estate risk models *(http://www.finma.ch/d/beaufsichtigte/versicherungen/schweizer-solvenztest/Documents/pruefkriterien-immobilienrisiko-modell-d.pdf* (available only in German)). It is as of the date of this article still unclear whether FINMA will in the end accept an interest rate sensitivity of real estate.

c) Definition and Aggregation of Scenarios

Art. 44 ISO gives FINMA the authority to define scenarios (the scenarios themselves as well as the probabilities). Based upon art. 45 ISO, FINMA has the authority to decide if and to which extent the results of these scenarios have to be aggregated by the insurance companies to the risk output of the SST model (the current status of the European Solvency II regime foresees that the scenarios are only used by the insurance companies in a qualitative way to validate the model output; Solvency II does not aggregate the scenarios to the model output). This leads to some risks being counted twice: If FINMA decides to test a stock market crash scenario and to aggregate the results of this test to the model output of the insurance companies, in effect the risk of a stock market crash is counted twice, because it is already accounted for in the risk model output. This leads to an additional capital requirement and a further competitive handicap compared to the European competition.

5) Conclusion

The SST framework is considered to be modern, adequate and reflecting the state of the art risk management techniques (Hato Schmeiser *et al., Volkswirtschaftliche Implikationen des Swiss Solvency Tests,* I VW HSG Schriftenreihe Band 48, 2006, p. 12).

Without dwelling on the fact that model based risk frameworks have failed the test of reality in the banking world (cf. Basel II/Basel III and the current state of banking in Europe; Dexia had to be bailed out by France, Belgium and Luxemburg and has been in effect terminated in October 2011 after having passed a *stresstest* in July 2011 (*Paris und Brüssel einigen sich auf Dexia-Plan,* Neue Zürcher Zeitung, 10 October 2011, p. 17)), the SST is here to stay and the insurance companies have learned to operate within this new framework.

However, the current regulation has some flaws. It appears that the SST allows FINMA to basically decide on the financial conditions of the entire Swiss insurance industry without any appropriate external control. What is constraining FINMA today is not

the legal framework of the SST but only the *competition* of the European regulators who are currently adapting the European Solvency II framework to make it more amenable to the requirements of the European insurance industry. Although the final details of the European Solvency II regime are not yet known, there is a distinct possibility that the Solvency II regime will be less capital demanding for life insurers than the SST, which would constitute a disadvantage for Swiss insurance companies, because they would have to operate their business with more capital than their European counterparts.

Whereas the valuation of assets and liabilities is described in a reasonable level of detail in the existing legal basis for the SST, which would allow a supervised entity to challenge a decision by FINMA, the risk model side of the SST is described only in a very high level manner and is therefore immune from legal challenges. Furthermore, FINMA has in practice a very substantial latitude to accept or reject the internal models of the various insurance companies as well as an almost unlimited authority to define and aggregate scenarios, which however could be challenged in an individual case based upon general legal grounds, such as the principle of proportionality or the prohibition of arbitrariness.

The SST is an innovative and comprehensive risk framework. However, there are aspects of the SST that distort the competitiveness of the Swiss insurance industry. In particular, it could be useful to better document the risk models and possibly to include the major parameters of the risk models in the ISO in order to define boundaries for FINMA and to ensure a level playing field in Switzerland. The risk scenarios should only be used for validation purposes, so that the scenario selection does not directly affect the SST.

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Update: Revision of Banking Act in Light of "Too Big to Fail"—The Swiss Parliament's View

Reference: CapLaw-2011-46

Following the draft bill dispatch to Parliament by the Federal Council in April, the revision of the Banking Act has recently been approved by the Parliament. For the most part Parliament followed the recommendations of the Federal Council with only a few changes made to the draft bill of 20 April 2011.

By Thomas U. Reutter / Daniel Raun

1) Parliament Approves Revision of Banking Act

Both the Council of States and the National Council voted in favor of the revision of the Banking Act in light of "Too Big to Fail" in their final votes on 30 September 2011. Prior to the approval, the Council of States and the National Council had dissented on a number of issues, including to what extent banks should profit from tax reliefs in connection with so-called CoCo (contingent convertible) and other bonds. The National Council, in addition to the changes in taxation already recommended by the Federal Council in the draft bill of April 2011 (Draft Bill), had proposed to exempt interest payments made in respect of issued bonds from the withholding tax duty, which proposal was rejected by the Council of States.

In the Conciliation Conference which took place towards the end of September, the representatives of the two councils agreed not to further ease tax treatment of such capital market instruments but to follow the initial proposals of the Federal Council. Accordingly, upon entering into force of the revised Banking Act, no stamp duty will be payable in connection with bond issuances but interest payments to bondholders will continue to be subject to withholding tax deduction.

2) Changes to the Draft Bill

Although the revision of the Banking Act was controversially discussed in Parliament, the final text of the revised Banking Act (rBankA) only shows few and mostly insubstantial changes. The capital requirements and capital adequacy measures remained unchanged. (These have been discussed in detail in CapLaw 2/2011, p. 15 et seqq.)

The most notable changes are of a procedural nature. Article 10 (2) rBankA has been amended and now provides that the Swiss Financial Market Supervisory Authority FINMA, when issuing a decision to a bank naming the requirements such bank has to fulfill under the Banking Act, shall inform the public about the main elements of such decision. Further, a new provision was added pursuant to which the Federal Council shall, after an initial three years after the entering into force of the rBankA and then in two year intervals, compare the new provisions to international standards and as-

sess and report to Parliament whether and to what extent there is a need to adapt and amend the Banking Act and the respective ordinances (article 52 rBankA). Finally, the rBankA now states that the Federal Council's implementing ordinance which will specify in detail the requirements and measures will need to be approved by Parliament prior to its enactment.

The referendum period expires on 19 January 2011. The date of the entering into force of the rBankA will yet have to be determined by the Federal Council.

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Implementation of New Basel III Rules on Capital Adequacy and Revision of Various FINMA Circulars

Reference: CapLaw-2011-47

On 24 October 2011, the Federal Department of Finance submitted a draft of the revised Capital Adequacy Ordinance (CAO) for public consultation. Simultaneously, FINMA launched a consultation on a new circular governing eligible equity capital and on the amendments to the circulars governing market and credit risks, disclosure and risk diversification. The suggested changes are mostly aimed at implementing the new capital adequacy rules of the international Basel III framework. The consultations for the CAO and the FINMA circulars end on 16 January 2012, and the new rules are to enter into force on 1 January 2013. A more detailed discussion of the draft CAO and FINMA circulars will be published in the next edition of CapLaw.

Capital Market Transactions VII (Kapitalmarkttransaktionen VII)

Wednesday, 23 November 2011, 09.15 h–17.00 h, Kongresshaus, Zurich

www.eiz.uzh.ch

AIFM Directive–Level 2 (AIFM Richtlinie–Level 2)

Wednesday, 30 November 2011, 12.00 h–17.45 h, Business Center Balsberg, Kloten

www.academy-execution.ch

St. Gallen Symposium on Financial Market Regulation (St. Galler Tagung zur Finanzmarktregulierung)

Friday, 2 December 2011, SIX ConventionPoint, Zurich

www.es.unisg.ch

Developments in Collective Investment Schemes Law VI (Entwicklungen im Recht der kollektiven Kapitalanlagen VI)

Thursday, 8 December 2011, 08.45 h–16.00 h, SIX ConventionPoint, Zurich

www.es.unisg.ch

Too big to fail

Thursday, 19 January 2012, 18.00 h–20.00 h, Zunfthaus Kämbel zur Haue, Zurich

www.zjurv.ch