CapLaw

SWISS CAPITAL MARKETS LAW

No. 3/2021

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Position Paper regarding selected Aspects of the Financial Services Act (FinSA)

Reference: CapLaw-2021-30

With the entry into force of the Swiss Financial Services Act (FinSA) as of 1 January 2020, new regulatory duties and requirements for Swiss and foreign financial service providers which are active in Switzerland or serve Swiss clients proactively on a cross-border basis were introduced. However, the practical application of the new law revealed that various newly introduced legal terms and concepts of the FinSA require more specific explanation and some statements made in the course of the implementation process require clarification.

The authors of this position paper are practicing lawyers working with various Zurich based law firms who regularly exchange views on new legal developments and share their experience in the application and implementation of the law. The views and positions expressed in this position paper are those of the individual contributing authors and not those of the respective law firms or other market participants.

1) Introduction – Subject Matter and Scope

Traditionally, Swiss financial market laws have provided for a rather liberal regulatory regime for the provision of financial services, which has been true in both the inbound cross-border as well as the domestic context. The Swiss Financial Services Act (**FinSA**), which came into force as of 1 January 2020, marked a paradigm shift in this regard and introduced new regulatory duties and requirements for Swiss and foreign financial service providers which are active in Switzerland or serve Swiss clients proactively on a cross-border basis. The newly implemented notion of financial services within the meaning of FinSA, inter alia, includes the "*acquisition or disposal of financial instruments*" as well as the "*provision of personal recommendations on transactions with financial instruments (investment advice)*".

A personal recommendation on transactions with financial instruments may either occur on a stand-alone basis, i.e., without taking into account the client portfolio, in which case it is referred to as "transaction-related advice", or under consideration of the client's portfolio, in which case it is referred to as "portfolio-related advice". However, if no personal recommendation is given to a potential investor, (i.e., if no recommendation is addressed to a specific client considering his or her needs), then no investment advice would be rendered to such an investor.

The term "*acquisition or disposal of financial instruments*" shall include any activity undertaken directly towards a particular client specifically aiming at the acquisition or disposal of financial instruments. According to the explanatory report of the Federal Department of Finance, dated 24 October 2018 and published in relation to the FinSA's implementing ordinance, the Financial Services Ordinance (**FinSO**), "marketing of" or "brokerage services in relation to" financial instruments would

typically fall within the scope of this provision and therefore qualify as a financial service. The second explanatory report of the Federal Department of Finance relating to the FinSO, dated 6 November 2019, however, also clarifies that the acquisition or disposal of financial instruments between regulated financial intermediaries shall not be considered as a financial service since the purpose of the legislation would be to protect the end client at the point of sale unless the financial intermediary is acting on its own behalf.

The authors of this position paper are of the view that the definition of certain legal terms and concepts newly implemented by the FinSA and the FinSO, such as financial services and brokerage, require more specific explanation and some statements made in the course of the implementation process require clarification, e.g. pure brokerage of financial instruments on behalf of the issuer of such financial instruments towards potential investors would *not qualify* as financial service pursuant to FinSA.

For any financial service provider proactively providing its services on a cross-border basis into Switzerland, a good understanding of, inter alia, the terms "financial instruments" and "financial services" implemented by the FinSA is crucial to safely navigate Swiss financial regulation. This position paper aims at resolving certain ambiguities of the new law. It has no claim of a comprehensive interpretation of the FinSA, the FinSO and the further implementation measures by the Swiss financial regulator FINMA and the self-regulatory bodies but reflects the interpretation of certain main topics by the authors only.

2) Financial Instruments

2.1) General

With regard to the substantive scope of the FinSA, "financial services" in the sense of article 3 lit. c FinSA have to relate to "financial instruments" in the sense of article 3 lit. a para. 1 to para. 7 FinSA. This list is exhaustive and covers the following:

1. equity securities (including, without limitation, securities that are convertible into equity securities);
2. debt securities (including, without limitation, notes and bonds);
3. shares or units in collective investment schemes;
4. structured products;
5. derivatives as defined in article 2 lit. c of the Financial Market Infrastructure Act (**FMIA**);

6. deposits, where the repayment or interests depend on an underlying or a market price (structured deposits), except for deposits with interest linked to an interest benchmark; and

7. other debt instruments structured with fungible terms (*Anleihensobligationen*).

Examples of assets/transactions that do not qualify as financial instruments for the purposes of the FinSA include the following:

– cash deposits or precious metals other than deposits mentioned under 6. above (see also article 3 para. 1 FinSO);

– commodities other than derivatives on commodities as underlyings falling under 5. above;

– participation in equity of an undertaking not qualifying as securities (*Effekten*), e.g. partnership interests; and

– cryptocurrencies (i.e. digital assets that are not the digital representation of any rights that can be exercised against an issuer or a third party).

Some questions require further consideration when interpreting the scope of FinSA-covered financial instruments.

2.2) Derivatives pursuant to Article 2 lit. c FMIA

Derivatives in the sense of article 3 lit. a para. 5 FinSA are defined by reference to article 2 lit. c FMIA. Such instruments are contracts (i) with a value depending on one or more underlyings, as resulting from the terms of the contract, provided that (ii) it is not a spot transaction.

For the purposes of this definition, note that transactions settled on a T+2 basis or within the relevant settlement cycle for spot transactions are excluded from the definition of a derivative and therefore do not qualify as "financial instruments" in the sense of article 3 lit. a para. 5 FinSA either. In line with the definition of spot transactions pursuant to the Financial Market Infrastructure Ordinance (**FMIO**), this would in our view also be true for rolling spot transactions, which are rolled without a pre-existing obligation to do so.

The FMIO excludes some derivatives from the definition of article 2 lit. c FMIA, i.e. those referred to under article 2 para. 3 lit. b and c FMIO. These derivatives are therefore also excluded from the definition of "financial instruments" in the sense of article 3 lit. a para. 5 FinSA.

Some derivatives within the meaning of article 2 lit. c FMIA are not subject to the obligations of articles 93-117 FMIA. This exclusion applies to physically settled derivatives on commodities as underlyings, provided they are not traded on a trading venue in the sense of FMIA or an organized trading facility. While these instruments are derivatives in the sense of article 2 lit. c FMIA, the question arises whether they should be excluded from the definition of a "financial instrument" in the sense of the FinSA. We believe that this should be so, because the exclusion from the obligations of article 93-117 FMIA was defined by reference to the scope of "financial instruments" under MiFID.

Other derivatives in the sense of article 2 lit. c FMIA (e.g. physically settled FX forwards and swaps) are exempted from only some of the obligations of articles 93-117 FMIA. These derivatives in our view qualify as financial instruments in the sense of the FinSA.

Additionally, any derivatives exempted from the obligations of articles 93-117 FMIA but falling under any of the categories of article 3 lit. a para. 1 to para. 7 FinSA other than para. 5 (e.g. structured products) would of course be qualified as "financial instruments" in the sense of the FinSA.

2.3) Digital Assets

While cryptocurrencies do not fall into any of the categories of article 3 lit. a para. 1 to para. 7 FinSA, this may be the case for other tokens, in particular asset tokens and possibly also utility tokens or hybrid tokens combining elements of different token categories (with regard to the classifications made by FINMA, reference is made to the FINMA guidelines on ICOs of 16 February 2018, as supplemented in respect of stable coins on 11 September 2019). These other tokens may be issued as DLT-rights in the sense of the new article 973d CO (as in force since 1 February 2021) or other uncertificated rights held in a distributed ledger (e.g. if issued under foreign law).

We believe that a "substance over form" approach should take place in respect of such tokens. Accordingly, the token should in our view be classified as a "financial instrument" in the sense of the FinSA, where the rights represented in the token fall into one of the categories of article 3 lit. a para. 1 to para. 7 FinSA (see also FINMA guidelines on ICOs of 16 February 2018, as supplemented on 11 September 2019). For this analysis, the "same business, same rules" approach taken by FINMA and the Swiss legislator should be considered. Therefore, if such tokens neither qualify as securities (*Effekten*) within the meaning of article 3 lit. b FinSA nor fall under any category of financial instruments as set forth under article 3 lit. a FinSA, then they are out of scope.

3) Financial Services for Clients

3.1) End Clients as Recipients of Financial Services

With regard to the definition of "financial services" in the sense of article 3 lit. c FinSA, the question may arise as to what extent issuers can be classified as financial service providers.

In relation to article 3 para. 2 FinSO, the explanatory report of the Federal Department of Finance relating to the FinSO of 6 November 2019 clarifies that the activity must be directed to the end clients directly in order to fall under the definition of "financial services" in the sense of article 3 lit. c FinSA. Hence, on the side of the recipients of financial services, only *end clients* are covered by the legal purpose of investor protection. However, the (end) client is neither defined in the law nor in the ordinance nor in the materials.

An end client is a client who obtains the financial service for himself, i.e. for his own account. As a result, prudentially supervised financial service providers are not deemed to be end clients if they purchase a financial service for the account of a third party (so-called *vostro business*). On the other hand, they are also deemed to be end clients if they purchase a financial service for their own account (so-called *nostro business*). The recognisable intention to resell to third parties not yet specified at the time of the financial service (usually clients) is sufficient in order for the prudentially supervised financial service providers not to be considered as the end client.

3.2) Issuers and Underwriters

On the basis of the aforementioned concept of end clients being the recipients of financial services, an issuer who interacts with an underwriter or with a distributor or other financial intermediary (i.e. not with the end investor / end client directly) could not be classified as a provider of "financial services" in the sense of article 3 lit. c FinSA.

Furthermore, the activity of an underwriter is excluded pursuant to article 3 para. 3 lit. b FinSO from the definition of providing "financial services" in the sense of article 3 lit. c FinSA. We take the view that this applies not only to an underwriting activity in a primary market offer, but also to an underwriting activity in a secondary market offer, even if the interaction of the underwriter is not with the issuer, but with selling investors holding the securities. We take the view that the underwriter acts in this context as a counterparty, not as a financial service provider of the seller or of the buying investor.

Likewise, the issuer who offers its own financial instruments to potential recipients (whether it be through brokers or not, or through a public offer or not) does not perform a financial service under FinSA. Rather, the issuer is acting in its own interest and not in the interest of the potential recipient (buyer of financial instruments). Acting "in the interest of a client" is however a pre-requisite for a financial service in the sense of article 3 lit. c FinSA.

3.3) Pure Brokerage (*reine Vermittlung*)

Pure brokerage of financial instruments *for the issuer* of such financial instruments towards potential investors (*reine Vermittlung*) – irrespective of the type of financial instruments under article 3 lit. b FinSA – does not qualify as a financial service pursuant to article 3 lit. c FinSA.

If the pure brokerage services (*reine Vermittlung*) are provided *for and in the interest of the potential recipient* (meaning the "end client" under the FinSA) of the financial instrument however, e.g. the broker is engaged by the potential recipient (i.e. "end client") to find interesting investment opportunities for the recipient, then such services qualify as financial services in the sense of the FinSA.

Accordingly, only if the broker (also) acts in the interest of the potential recipient ("end client"), the brokerage activity qualifies as a financial service under the FinSA. For example, if the broker is engaged by the issuer and accepts subscriptions from potential investors for which the broker (or the relevant department of the broker) does not provide any services related to the respective financial instrument(s), such acceptance of subscriptions does not qualify as financial service under the FinSA. This is also in line with the explanatory report of the Federal Department of Finance relating to the FinSO dated 6 November 2019, according to which the law regulates the legal relationship between a financial service provider and *its clients*.

The above concept applies regardless of the type of financial instruments at issue. The legislators intended to introduce a product-independent concept for the provision of financial services.

3.4) Reverse Solicitation

Based on the reverse solicitation exemption, financial services provided to clients in Switzerland by foreign financial service providers are not covered/governed by the FinSA if (i) the entire client relationship or the individual/specific financial services have been requested by clients on their express initiative, (ii) the relevant specific financial service has not been advertised or solicited by any other means to the relevant client prior to such client's enquiry, and (iii) the service in question does not go beyond the scope of the original request.

Therefore, the reverse solicitation results in a narrow exemption. Reverse solicitation is not a business model in the sense that the market can by systematically worked – the purpose of the exemption is not to simplify market access for foreign financial service providers.

The client's inquiry must relate to a specific financial service, financial instrument or type of financial instrument; mere general inquiries about the company or persons are not sufficient. To comfortably rely on the reverse solicitation exemption, the original request of the client should therefore be documented by the financial service provider; *ex post*

confirmation by the client is generally not sufficient but is probably only circumstantial evidence. If a client relationship was entered into on the initiative of the client, all financial services that fall under this client relationship (i.e. this requested service) are covered by the reverse solicitation exception (e.g.: individual advisory services in the case of an advisory relationship, or individual investment decisions and related acts in the case of an asset management relationship; but not: "recommendation" of an asset management relationship in the case of an existing advisory relationship). The extension of, i.e. the provision of further, financial services that are not requested by the client is not possible based on reverse solicitation.

Client relationships entered into prior to the entry into effect of the FinSA can be continued under the FinSA if they have been the result of reverse solicitation and would not be subject to the FinSA and its requirements.

3.5) Relevance of Definition of Client

3.5.1) Client / Counterparty

Clients in the context of FinSA are individuals, legal entities, partnerships and other legal entities formed under foreign law, with the dispatch to the Financial Services Act of 4 November 2015 (**Dispatch**) citing the trust as an example of the latter. In our view, with regard to clients of a financial service provider, there is no reason to treat the trust differently than under the previous practice to article 3 Anti-Money Laundry Act (**AMLA**) and the Automatic Exchange of Information and Foreign Account Tax Compliance Act (**FATCA**), which is why the trustee should also be treated as a contractual partner and thus as a client with regard to the provision of a financial service.

According to the Dispatch, a person approached for the *potential provision* of a financial service should already be considered a client of the financial service provider, i.e. without an agreement having already been concluded between the financial service provider and the client. However, in our view, the term "financial service", the legal wording of the introductory sentence of article 3 lit. c FinSA ("Financial services: the following activities provided to clients") as well as the activities clearly and conclusively listed in article 3 lit. c FinSA preclude such a broad interpretation of the term "client" by the Dispatch in the absence of a legal basis. The mere contacting of potential clients with a view to promoting financial services is not itself a financial service, but only when the financial services are contractually agreed and/or effectively provided.

It does not matter in what form the contractual relationship between the financial service provider and the client is concluded (i.e. FinSA may apply before the onboarding of the client is documented).

As proprietary trading transactions lack any elements of interest protection, the involved transaction parties do not qualify as clients within the sense of FinSA. Such proprietary

trading transactions are often seen in connection with OTC derivative transactions under an ISDA Master Agreement or Swiss Master Agreement.

3.5.2) Client Segmentation

3.5.2.1) Client Segmentation Duty

Pursuant to article 4 para. 1 FinSA, financial service providers must assign clients to whom they provide financial services to one of the following three client categories or segments: retail clients, professional clients and institutional clients. Alternatively, according to article 4 para. 7 FinSA, financial service providers may refrain from client segmentation, provided they treat all clients with the highest level of protection of the retail client.

At least based on the duty of information and clarification of the financial service provider towards its client, the client probably has the right to information about its client status pursuant to article 4 FinSA vis-à-vis its financial service provider at any time, but at least always before the conclusion of a contract or before the provision of a (financial) service.

The Swiss legislator has explicitly not granted the Federal Council any competence to designate further categories of professional clients at ordinance level. In this sense, the listing of professional clients is of an exhaustive nature.

The status as a professional client is linked to more or less clearly verifiable criteria, which must in principle be met on an ongoing basis. However, financial service providers should not be required to continuously monitor whether the criteria for the client qualification are still met. Thus, in the absence of any indications to the contrary, the financial service provider may rely on the initial information credibly provided by, or available with respect to, the client and the client relationship.

The financial service provider may carry out a segmentation according to foreign law such as MIFID II, although it remains responsible for determining whether and to what extent this is to be considered as equivalent to the FinSA.

3.5.2.2) Multiple Relationships and Client-Representing Third Parties

A client may have several client relationships with a financial service provider, each of which must be segmented separately and for each of which the opting-in/out rule applies separately. If, pursuant to article 4 para. 1 FinSO, assets are owned by several clients, these clients have to be categorized in the client category with the respective highest level of client protection.

Pursuant to article 4 para. 2 FinSO, clients acting through an authorised person may agree with the financial service provider in writing or in another form demonstrable via text that their allocation to a segment is based on the knowledge and experience of

that person. Thus, upon explicit declaration by the client, an attribution of the knowledge and experience of the authorised person takes place. This can be used, for example, by retail clients or SPVs that use prudentially supervised external asset managers or are represented by other prudentially supervised financial institutions.

3.5.2.3) High-Net-Worth Retail Clients and Private Investment Structures

In our view, the category of high-net-worth retail clients is designed for individuals and, except where individuals act through private investment structures created for these individuals, not for companies. It is precisely for companies that the category of "large company" was created pursuant to article 4 para. 3 lit. h FinSA. However, a more liberal approach may be taken in practice by market participants, according to which companies may also qualify as high-net-worth retail clients within the meaning of article 5 FinSA. As a result, companies would also be able to declare an opting-out. In any event, the wording of the FinSA and the FinSO as well as the materials would not exclude such interpretation.

While the wording of the law requires a combination of personal education and professional or comparable experience, we are of the view that the "education" requirement and the "experience" requirement are to a certain extent interchangeable and, therefore, a high degree of education may compensate for a lack of experience – and vice versa. Under the old Federal Act on Collective Investment Scheme (**CISA**), FINMA defined "comparable experience", for example, as the case where the investor has executed an average of 10 transactions of significant size per quarter on the relevant market during the four preceding quarters (FINMA-Circ. 13/9 n 16, not in force anymore). In our view, this also applies under the FinSA, although the criterion of the "relevant market" is likely to become more important due to the wider range of financial instruments covered under the FinSA. Otherwise, it remains in the reasonable discretion of the financial service provider to interpret the criteria of sufficient training as well as professional and comparable experience of the clients.

Since professional qualification is in principle imperishable, a one-off declaration or proof should be sufficient in this respect. However, the required minimum assets are subject to fluctuations over time (see above section 3.5.2.1).

The term private investment vehicle is not defined in FinSA. However, according to the previous literature on the old CISA, a private investment structure is understood as "transactions" in which one or more – for the present purposes "wealthy" – retail individual(s) (e.g. a family), usually as settlor, founder, policyholder or premium payer, dedicate portions of assets to a special purpose and therefore contribute them to an investment structure. In doing so, these typically do not pursue an operational purpose, but rather focus – often without a market presence – on the discretionary organisation of the management of the assets dedicated to it and are therefore usually considered domiciliary companies pursuant to article 6 para. 2 et seq of the Anti-Money Laundering Ordinance (**AMLO**).

The legal form can be contractual or corporate, with foundations, institutions or companies domiciled in offshore jurisdictions, trusts, insurance wrappers or specially structured investment products (e.g. single-investor funds) often being used.

3.5.2.4) Opting-Out/-In

The following comments in the Dispatch on the obligations of the financial service provider in the event of an opting-out requirement by a high-net-worth retail client are likely to apply to all opting-out options:

a) the financial service provider must inform clients of the consequences, in particular the risks of such a waiver of protection under the specific opting-out (duty of clarification and information);

b) in the event of a waiver, it must also inform the client that he is obliged to report any changes in circumstances to the financial service provider (obligation to report changed circumstances);

c) as soon as the financial service provider learns of new facts or changes, it must clarify the new circumstances again and determine whether the requirements for an opt-out are still given (duty to clarify changed circumstances).

The Swiss legislator incomprehensibly limited the opting-in possibilities for institutional clients explicitly in such a way that they cannot be considered retail clients. This makes little sense, because if a financial service provider waives client segmentation, it must treat all clients – and thus also institutional clients – as retail clients.

3.5.3) FinSA Client / Investor according to CISA

Under the old CISA, potential investors were also covered by the term "investor", e.g. in relation to advertising, distribution, contract initiation and the acquisition of units. In our opinion, this broad interpretation of the investor concept including the potential investor should no longer be applicable with the entry into force of the FinSA, because the concept of qualified investor refers to the professional client under the FinSA, the distribution regime has been abolished and the concepts of advertising, offer, financial service provider and financial service are now regulated uniformly across sectors in the FinSA.

The transitional provision in article 103 FinSO concerning the two-year transitional period for the introduction of client segmentation only relates to client segmentation under FinSA, but not to the one under CISA. Thus, the adjustments to client segmentation under CISA already started to apply as of 1 January 2020.

4) Further Selected Aspects

4.1) Definition of "Acting on a Commercial Basis" (*Gewerbsmässigkeit*)

Only those persons who provide financial services according to the FinSA on a commercial basis (*gewerbsmässig*) qualify as a financial service provider in the sense of the FinSA. The definition of "acting on a commercial basis" is defined by article 3 lit. d FinSA as an independent economic activity pursued on a permanent, for-profit basis (*selbständige, auf dauernden Erwerb ausgerichtete wirtschaftliche Tätigkeit*).

Acting on a commercial basis in this regard must relate to the activity of performing financial services in the sense of the FinSA. It is not sufficient if the respective person performs other activities which qualify as commercial activity, but which are not related to financial services in the sense of the FinSA.

Although the Dispatch states that acting on a commercial basis may be assumed if financial services "for more than 20 clients" (see page 8947 of the Dispatch) are provided, the activity must still be carried out on a for-profit and permanent basis. Hence, the mere fact that financial services have been rendered to more than 20 clients of the service provider is not yet sufficient to qualify as acting on a commercial basis (*Gewerbsmässigkeit*) in the sense of the FinSA and hence does not yet qualify as a financial service provider under the FinSA.

4.2) Requirement for "Best Execution"

4.2.1) Legal Nature: Supervisory Law

Unlike the predecessor provisions of article 11 of the old Federal Act on Act on Stock Exchanges and Securities Trading (SESTA) and articles 20 and 22 of the old CISA, the conduct of business requirements for "best execution" under article 18 FinSA is purely supervisory law and, in particular, not a double standard provision (supervisory law/civil law).

4.2.2) Applicability to Secondary Market (principle)

The rules of the FinSA on the allocation and execution of orders do not in our view apply to primary market transactions (market on which the initial offer/sale of a newly issued financial instrument takes place) – to the extent that they constitute a financial service at all. Rather, financial institutions continue to be allowed to follow allocation principles established in the Swiss market.

4.2.3) Addressed to Financial Service Providers in their Activities vis-à-vis End Clients

The provision of article 18 FinSA applies by its wording to all persons in their function as financial service providers. Several intermediaries (e.g. third-party brokers) are regularly involved in the execution of a client order.

The following is true for external asset managers in particular: In connection with the acquisition and sale of financial instruments, external asset managers are obliged to ensure that intermediaries who are commissioned by them to execute investment decisions comply with article 18 FinSA. As a rule, the external asset manager may rely on the execution policy of the intermediary complying with the legal requirements and that the intermediary adheres to such policy. Therefore, applying appropriate selection criteria with respect to a custodian bank (which is involved in the execution) is critical. We take the view that external asset managers do not have to take article 18 FinSA into account when recommending a custodian bank to the client, since this activity is not a financial service within the meaning of the FinSA.

4.2.4) Applicability to Client Orders in Connection with the Provision of Financial Services

According to article 18 para.1 FinSA, financial service providers must ensure compliance with the best execution obligation "when executing the orders" of their clients. The wording of the provision, when read in isolation, opens up a very broad material scope. However, the subject matter of the FinSA of interest here is limited to the provision of financial services (see also above sections 1, 2.1 and 4.1). The scope of article 18 FinSA therefore only covers the execution of client orders which qualify as financial services to *clients*, and the relevant financial services are the acquisition or disposal of financial instruments as well as the acceptance and transmission of orders for *clients* (article 3 lit. c para. 1 and article 3 lit. c para. 2 FinSA).

4.2.5) Best Possible Result in Financial, Temporal and Qualitative Terms

Financial service providers must ensure that the best possible result in financial, temporal and quantitative as well as qualitative terms is achieved in the execution of their clients' orders (article 18 para. 1 FinSA). In our view, the best execution obligation in article 18 FinSA is satisfied if the financial service provider *strives to achieve* the best possible overall result for its clients, taking into account, within the limits of the client instruction, all relevant circumstances (in particular market environment, diverging client interests, etc.). – Cf. on best execution in the EU: "This overarching requirement should not be interpreted to mean that a firm must obtain the best possible results for its clients on every single occasion" (ESMA, Questions and Answers, On MiFID II and MiFIR investor protection and intermediaries topics, December 4, 2019, 18).

Also, the best execution obligation does not impose any substantive requirements on the product range of the financial service provider, namely on the selection and quality of the financial instrument to be acquired or sold. Execution takes place after the selection (and is separate from it).

In contrast to the EU, the FinSA does not require the client to agree to the financial service provider's execution policy.

4.2.6) Legitimate Reliance

Under MiFID I, the European Commission introduced the four-fold trading relationship test (Four-Fold Test or Legitimate Reliance) in connection with the execution of orders from retail and professional clients under EU law. This test remains in place under MiFID II. It enables investment firms to check whether a client may legitimately rely on the execution circumstances to ensure that his order is executed in accordance with best execution principles. The test is based on the following four questions: (1) Did the initiative for the transaction come from the client? (2) Does the client have the opportunity, based on existing market practice, to obtain price quotations from different suppliers (i.e. to shop around)? (3) Is the relative price transparency of the financial instrument requested by the client high and available on the market? (4) Does the information provided to the client by the investment firm and the contractual arrangements between the parties indicate that some or all of the best execution principles are not applicable? If all the answers to these questions are in the affirmative, it is less likely that the (usually professional) client may legitimately rely on compliance with the Best Execution Principles. The Federal Council has expressly refrained from introducing the four-fold test because the "complicated and also not easily communicable regulation" is not compatible with Switzerland's principle-based regulation. However, this does not exclude that the test is also applicable under the regulation of article 18 FinSA, and we take the view that it in fact is.

4.3) Specialties and Challenges with Client Advisor Registration

4.3.1) Inbound Cross-Border Aspects

The FinSA also applies to non-Swiss financial service providers if they provide their financial services to clients in Switzerland (with the exception of "reverse solicitation", see section 3.4 above). A client in Switzerland is a client that is either:

- an individual that is permanently resident in Switzerland;
- a legal entity that is incorporated in Switzerland;
- a Swiss branch of a non-Swiss legal entity.

Non-Swiss branches of Swiss legal entities should not be considered as "clients in Switzerland". The same should apply to individuals that are merely temporarily in Switzerland, e.g. for purposes of vacation or a business trip or conferences.

Providing financial services is in many jurisdictions a regulated activity and non-Swiss financial service providers are therefore often already subject to financial services rules and regulations in their respective home jurisdiction. Thus, the question arises whether a non-Swiss financial service provider can rely on its home country conduct and organizational rules and requirements, instead of applying similar rules laid out in the FinSA. While the FinSA does not provide for an explicit substituted compliance

regime (in fact, such a substituted compliance regime was removed from an early draft of the legislation), it was the clear intention of the Swiss legislators that the FinSA should not exceed comparable requirements and rules under the European laws and regulations (in particular MiFID II). Accordingly, to the extent that a non-Swiss financial service provider complies with MiFID II (and the relevant national implementing laws) when servicing clients in Switzerland, such non-Swiss financial service provider should, for the most part, also meet the requirements of the FinSA. This is particularly true for a client segmentation that is equivalent to the FinSA rules (such as, for the most part, MiFID II, which is explicitly mentioned in the explanatory materials as an equivalent standard).

In consideration of the above, it is worth noting that the FinSA provides for a number of Swiss features and differences compared to other regulations, such as MiFID II. Therefore, non-Swiss financial service providers will have to nonetheless analyze their existing policies and procedures in light of the requirements of the FinSA. This is of particular importance because non-compliance with certain specific FinSA requirements and features may result in enforcement action or criminal proceedings. These specific Swiss features also apply to non-Swiss financial service providers:

- *obligation to disclose compensation received from third parties (e.g. retrocessions, kickbacks and similar payments)*. Such payments need to be either handed over to the client or the client explicitly must waive claims to such payments;
- requirement to *affiliate with an ombudsman service*, provided the non-Swiss financial service provider offers its services to retail clients and/or opting-out professional clients (such as high-net worth individuals);
- requirement to *register client advisors with a Swiss client advisor register* (subject to certain exemptions).

In terms of the afore-mentioned requirement to register the client advisors, the FinSA provides for an exemption for foreign financial service providers that are prudentially supervised in their respective home jurisdiction and that offer their services exclusively to professional clients or institutional clients (see also section 4.3.2 below). As for the requirement of a "prudential supervision", the FinSA neither specifies this term nor stipulates any equivalence or appropriateness requirements. Considering the type of Swiss financial institutions that would be considered as prudentially supervised (the lowest level of supervision being that of portfolio managers or trustees), "prudential supervision" generally requires that the relevant foreign financial service provider is:

- subject to ongoing supervision (as opposed to a mere one-time registration without ongoing obligations);

- subject to basic minimum capital and organizational requirements; and
- supervised with respect to capital and other organizational requirements as well as compliance with applicable rules of conduct.

The term "client advisor" is limited to the individual actually maintaining the client relationship (i.e. individuals that have meaningful client-facing interactions). Individuals in a mere supporting function (such as middle and back office) are not considered "client advisors". The same applies to experts with specific area of expertise, provided they are brought in by the individual that is otherwise responsible for maintaining the client relationship. Where there is no such individual (e.g. where a financial service is exclusively rendered through a digital platform), no client advisor registration is required. In particular, the client advisor registration obligation should not be seen as a "back-door" registration obligation for any non-Swiss financial service providers.

If a financial service provider has a client advisor that meets the above criteria, then such a client advisor needs to be registered in the Swiss client advisor register prior to providing financial services to a client in Switzerland. Using a chaperone (i.e. an already registered client advisor) does not free the client advisor from its registration obligation, provided such chaperone is not otherwise involved in maintaining (in a meaningful way) the client relationship.

4.3.2) Exemption for Foreign Financial Service Providers subject to Prudential Supervision

An exemption from the client adviser registration duty applies to client advisors of foreign financial service providers that are prudentially supervised in their home jurisdiction, if such client advisors render their services in Switzerland exclusively to professional and institutional clients (article 28 para. 2 FinSA and article 31 FinSO; see also section 4.3.1 above).

In defining the exemption (or, rather, the delegation of the power to the Federal Council to enact an exemption by way of an ordinance), the FinSA refers to "professional and institutional clients within the meaning of article 4 FinSA". According to article 4 FinSA, professional clients include, in particular, regulated financial intermediaries, central banks, large companies and certain entities with professional treasury operations ("*per se* professional clients"). Clients that do not qualify as professional clients are considered to be retail clients. A subset of professional clients and certain additional client types qualify as institutional clients. Further, pursuant to article 5 FinSA, high-net worth individuals and their private investment structures have the right to opt out of the retail client regime and elect instead to be treated as professional clients ("opting-out professional clients" or "elective professional clients").

The wording of article 28 para. 2 FinSA raises the question as to whether the full scope of professional clients including opting-out professional clients is intended to be covered by the rule. The view taken in this position paper is affirmative, *i.e. client advisors of prudentially supervised foreign financial service providers that serve a client base in Switzerland composed exclusively of institutional clients, per se professional clients and opting-out professional clients in line with the requirements of the FinSA are exempt from the obligation to register in the client adviser register*. The requirements of the exemption must be fulfilled at the level of the individual client advisor, not with respect to the entire client base of the foreign financial service provider.

We note that this view has been challenged in an FAQ published by the three admitted Swiss client adviser registration bodies, who interpret the exemption more narrowly such that client advisors serving opting-out professional clients would need to be registered and only the service provision to institutional and *per se* professional clients would be exempt. FINMA has "taken note" of the FAQ in its English language version.

There are various arguments supporting the view taken in this position paper, in particular the following:

- article 28 para. 2 FinSA was introduced in the course of the parliamentary deliberations. At no point in the discussions in the Swiss parliament was any distinction between opting-out and *per se* professional clients discussed for the purposes of this provision. Furthermore, while the Federal Council could conceivably have limited the scope of the rule when implementing the exemption in the FinSO under the power delegated to it, it did not do so in any way;

- the extraterritorial scope of the client adviser registration requirement (and other provisions of the FinSA) is an uncommon and unusual concept in Swiss financial regulation and Swiss law in general. Where there are ambiguities in the law, a restrictive interpretation limiting the extraterritorial application must be favoured. Therefore, the reference in article 28 para. 2 FinSA to professional and institutional clients "within the meaning of article 4 FinSA" must be understood as a general reference to the client classification system, the *sedes materiae* of which is in article 4 FinSA. Article 5 FinSA merely builds on that system, setting out the eligibility conditions under which a retail client may declare an opting-out. However, once such declaration is made, the client is for all intents and purposes – a professional client in the sense of article 4 para. 1 lit. b FinSA (conversely, a professional client having opted into the retail client regime must be considered a retail client also for the purposes of the client adviser registration exemption, again even though the opting-in right is set out in article 5 para. 5 FinSA);

- *per se* and opting-out professional clients are also otherwise treated equally in all respects (or, rather, not distinguished between) under the FinSA, in particular when

> it comes to the duties of diligence to be observed by financial service providers and their client advisors. This is in line with the legislative intention of including an opting-out right in the first place. One area where a distinction between *per se* and opting-out professional clients is made is for the purposes of determining whether a financial service provider is required to join an ombudsman's organization (article 77 FinSA). However, compared to the client advisor registration exemption, the ombudsman rule is drafted more narrowly at the level of the FinSA itself – exempting only financial service providers that exclusively serve professional and institutional clients pursuant to article 4 para. 3 and 4 FinSA – and is available to both domestic and foreign financial service providers without regard to their regulatory status. This is an important distinction, as the exemption from the client advisor registration duty is available for client advisors of foreign prudentially regulated financial service providers only, ensuring a level of client protection by way of reliance on the foreign regulatory regime.

No registration requirement applies to client advisors of FINMA-licensed branches of foreign banks or foreign financial institutions. With regard to FINMA-licensed *representative offices* of foreign banks or foreign financial institutions, draft amendments have been proposed to the Banking Ordinance (**BankO**) and the Financial Institutions Ordinance (**FinIO**) which would state that if financial services within the meaning of the FinSA are rendered out of the representative office, the relevant client advisors have to be registered in a Swiss client advisor register if they provide financial services to *retail clients*. While the amended provisions are not final yet, they do show a continuation of the line of thinking pursuant to which the provision of financial services to *retail clients* (and not to opting-out professional clients) is the key trigger for the registration duty as applicable to client advisors of foreign financial services providers.

Given the statements in the FAQ and the fact that FINMA "took note" of it, foreign prudentially regulated financial service providers should carefully consider their approach depending on the composition of their Swiss client base and should continue to monitor the developing legal practice in Switzerland.

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CapLaw
SWISS CAPITAL MARKETS LAW

Are Insurers Permitted to Operate Innovative Business Models?

Reference: CapLaw-2021-31

Swiss (re)insurers are generally prohibited from conducting business not directly linked to the insurance business. The dispatch of the Swiss Federal Council on the partial revision of the Insurance Supervision Act states that the current prohibition of insurance companies to conduct non-insurance business will remain in place. At the same time, the partial revision of the Insurance Supervision Act aims to enhance the competitiveness of the Swiss insurance sector and to further innovative business models. To overcome this conflict of objectives, the authors argue for a narrow interpretation of the prohibition on the conduct of non-insurance business and outline ways for insurers to operate non-insurance business.

By Hansjürg Appenzeller / Kevin M. Hubacher

1) Overview

Disruptive technological developments, societal megatrends and the rise of new competitors (*e.g.*, big data companies) challenge existing business models of direct insurers and reinsurers alike (in the following referred to as insurers or insurance companies only). Challenges create opportunities, though. New developments and trends hold great potential for growth initiatives and for more stable and resilient business cases. Insurers thus strive to develop customer-centric products and services, to increase the efficiency of their business processes and to monetize certain features of their value chain. However, regulated insurers and unregulated market players are not acting on a level playing field. The Insurance Supervision Act of 17 December 2014 ("**ISA**") limits the activities that insurance companies may carry out. Pursuant to article 11 ISA, insurers are, in addition to the operation of their insurance business, only allowed to conduct business that is directly related to the insurance business. The same prohibition on the conduct of non-insurance business is also included in the European Directive on The Taking-Up and Pursuit of the Business of Insurance and Reinsurance (Solvency II) (Directive 2019/138/EC) and the Agreement of 10 October 1989 between the Swiss Confederation and the European Economic Community on Direct insurance other than Life Insurance.

The prohibition on non-insurance business is to be seen in the broader context of the ultimate purpose of financial market supervision which is guided by the following five principles of protection: individual protection (*Individualschutz*), functional protection (*Funktionsschutz*), reputation protection (*Reputationsschutz*), trust protection (*Vertrauensschutz*) and system protection (*Systemschutz*). Hence, the rationale to prohibit the conduct of non-insurance business by insurers is to protect the insured persons from any non-supervised activities that may put their interests into jeopardy (*cf.*, articles 1(2) and 11(2) ISA). Legal doctrine tends to suggest that non-insurance business poses a "contamination risk". The Swiss Federal Supreme Court, for example,

is of the view that the Swiss Financial Market Supervisory Authority FINMA (FINMA) would not be able to properly carry out its supervision duties in case an insurer also carries out non-insurance business (see BGE 94 I 616 *et seqq.*, cons. 3).

Article 11 ISA needs to be interpreted. Legal writing is scarce on the subject with the exception of a recently published dissertation thesis (see JANNICK KOLLER, Der Begriff des versicherungsfremden Geschäfts im Versicherungsaufsichtsrecht, Diss. Zürich/St. Gallen 2020) and the *Basler Kommentar* on the ISA. In this paper, the authors call for a narrow interpretation of the prohibition to operate non-insurance business by pointing out a variety of relevant aspects that should be considered when interpreting article 11 ISA. In addition, this paper outlines different structuring options for insurers (and insurance groups) to operate non-insurance business. This is relevant given that the revised ISA is expected to hold on to the prohibition to operate non-insurance business.

2) Relevant Changes under the Revised Insurance Supervision Act

On 21 October 2020, the Swiss Federal Council adopted the dispatch for a partial revision of the ISA together with the draft of the revised ISA ("**D-ISA**") (BBl 2020 8967 *et seqq.*). The D-ISA has not loosened the prohibition of non-insurance business and continues to only allow insurers to conduct business that is directly related to insurance business (article 11(1)(a) D-ISA). As is currently the case, insurers may, with FINMA's approval, to a limited extent provide services that are not directly related to the insurance business (article 11(1)(b) D-ISA). Details will be set forth in the implementing ordinance to be enacted by the Swiss Federal Council (article 11(2) D-ISA). In our view, the wording of article 11(1)(b) D-ISA would leave room for a legal basis that is more favorable to non-insurance business and, in particular, innovation as long as corresponding risks for insured persons are confined.

In this context, it is worth noting that the partial revision of the ISA aims, among others, to enhance the competitiveness of the Swiss insurance sector and to encourage innovative business models. As an example, the dispatch on the partial revision of the ISA allows for small insurers to be excluded from insurance supervision as such (BBl 2020 8985 *et seq.*). This is because, in the view of the Swiss Federal Council, the development of innovative business models is hardly visible in the insurance sector, or only to a limited extent, compared to the banking sector. When setting the provisions of the implementing ordinance, the Swiss Federal Council intends to promote innovative business models but without undermining adequate protection of insured persons. It remains to be seen whether such commitment by the Swiss Federal Council will spill over to FINMA's practice when it comes to the approval of non-insurance business operated by insurers.

3) On the Prohibition of Conducting Non-Insurance Business

The ISA stipulates that, in the absence of FINMA approval, insurers are permitted to only conduct insurance business and business that is directly related to the insurance business (article 11(1) ISA). Conducting non-insurance business is thus prohibited unless specifically authorized by FINMA. According to its established practice, FINMA is reluctant to grant such authorizations.

The legislator distinguishes between insurance business (*Versicherungsgeschäft*), business directly related to insurance business (in the following, the term "insurance-related business" is used for the sake of readability) (*Geschäfte, die in unmittelbarem Zusammenhang mit dem Versicherungsgeschäft stehen*) and non-insurance business (*versicherungsfremdes Geschäft*). FINMA may authorize the operation of non-insurance business if such business does not jeopardize the interests of the insured persons (article 11(2) ISA).

The question is therefore how the terms "insurance business", "insurance-related business" and "non-insurance business" are interpreted.

a) Insurance Business

The term "insurance business" consists of the two concepts of "insurance" and "business". Neither the ISA nor the Insurance Contract Act of 2 April 1908 (ICA) defines the term insurance. The Swiss Federal Supreme Court defines the concept of insurance on the basis of the following five cumulative characteristics (*see* BGE 114 Ib 244 *et seq.*, cons. 4a; 2C_410/2010, cons. 3): (i) Assumption or transfer of risks or hazards, (ii) payment by the insured (premium), (iii) performance of the insurer, (iv) self-sufficiency of the operation, and (v) compensation of risks according to the laws of statistics (structured business operations).

Neither the ISA nor the Insurance Supervision Ordinance of 9 November 2005 ("**ISO**") defines the term "business" (*Geschäft*). According to conventional German dictionaries, the term "business" stands, among others, for "an undertaking aiming at profit". In article 11(1) ISA, however, this term refers to the operation of a business (*cf.*, article 181 of the Swiss Code of Obligations 30 March 1911 ("**CO**")). Hence, an insurance business constitutes a unit organized under commercial law within the framework of which insurance and insurance-related activities are independently carried out with the purpose of generating income. This understanding of the term also corresponds to the concept of business used in both the ISA and the ISO (*e.g.*, article 4(2) ISA, article 14(1) ISA, article 16(1) ISA, article 3(1) ISO). During the parliamentary deliberations on the predecessor legislation of today's ISA, insurance business was described as the "planned performance of business activities in accordance with actuarial principles" (see Official Stenographic Bulletin of the Federal Assembly of 9 March 1977, 76.042 Insurance Supervision Act, 28 *et seqq.*, 28).

To carry out insurance business in accordance with commercial principles, a wide variety of business processes are required. These are commonly divided into core functions and necessary support functions. Core functions are those business processes that are part of the value chain. They include product development, production, sales and distribution (*e.g.*, advertising, deploying and using third-party services or applications to provide additional sales channels), underwriting (*e.g.*, conducting risk assessments and pricing), portfolio management and claims management. The various core functions are part of the insurance business. Support functions are those business processes that are not directly part of the value chain of the insurance business but are required to ensure it. These include, for example, investment management, accounting, IT services and control processes such as compliance, risk management, or internal audit. The support functions are indispensable components of an insurance business and thus form part of the insurance business.

b) Insurance-Related Business

Insurance-related activities are those business activities that are directly related to the insurance business. The line between what constitutes a core function and a necessary support function is thin. An insurance-related activity may, for example, consist of offering services that aim to reduce the probability of the occurrence of an insured risk or to identify or reduce possible risk occurrences and dangers at an early stage.

The term "direct connection" (*unmittelbarer Zusammenhang*) can be interpreted either operationally or functionally. While the operation-related interpretation only assumes a direct connection if the activity directly serves the insurance business of the concerned insurance company as such, the functional interpretation does not make such limitation and assumes a direct connection if the activity is linked to insurance business as such. The functional interpretation deserves priority in our view. For purposes of supervision, it is, in our view, decisive whether FINMA is able to assess potential risks arising out of the insurance-related activities regardless of whether or not they directly serve the insurance business of the concerned insurer. This view is in line with a ruling of the Swiss Federal Supreme Court, which points out that the prohibition to operate non-insurance business shall ensure that FINMA can sufficiently supervise the financial situation of an insurance company (*cf.*, BGE 94 I 616 *et seqq.*, cons. 3).

c) Non-Insurance Business

All business activities that do not represent core functions, necessary support functions and insurance-related activities qualify *e contrario* as non-insurance business. Having said that, the potentially high risk exposure of a specific insurance-related activity should not result in the qualification of such activity as non-insurance business merely because of such high risk exposure.

In addition, it is important to note that an insurer which directly or indirectly holds a company that conducts non-insurance business does not itself carry out non-

insurance business within the meaning of article 11(1) ISA (see Dispatch of the Swiss Federal Council on the Insurance Supervision Act and the Amendments to the Insurance Contract Act of 9 May 2003, BBl 2003 3789 *et seqq.*, 3793). Therefore, the prohibition applies exclusively to insurers and not to their direct or indirect subsidiaries (that themselves are not insurers).

d) Business Operations

Article 11(1) ISA prohibits the "operation" (*Betrieb*) of non-insurance "business" (see Section 3)a) above). The law does not define the term "operation".

Parts of the doctrine (see Renato Degli Uomini/Hans-Peter Gschwind, Basler Kommentar Versicherungsaufsichtsgesetz, Basel 2013 [zit. BSK VAG], article 11 N 30 *et seqq.*) seem to assume that the prohibition also covers individual non-insurance transactions that are not carried out as part of a planned and permanent operation. In our opinion, however, neither the terms "operation" or "business" nor the purpose of the insurance supervision support such a broad interpretation. In addition, an overly restrictive interpretation restricts insurers unnecessarily in their freedom to act.

Therefore, individual transactions are in our view not in scope of article 11(1) ISA unless such transactions pose a risk that is similar to the risk exposure of a planned and permanent non-insurance business operation. Whether or not a non-insurance business activity is offered for free is not decisive with regard to such activity's qualification as an "operation".

e) Offering Core Functions and Necessary Support Functions to Third Parties

A much disputed issue concerns the offering of parts of the core functions and the necessary support functions to third parties. Parts of the doctrine are of the view that the offering of core functions and necessary support functions does not constitute insurance business but might qualify as an insurance-related activity (see Degli Uomini/Gschwind, BSK VAG, article 11 N 36).

As stated above, we are of the view that these core functions and support functions form part of the insurance business. There is no legal requirement that any business operated by the insurer must in any case involve a risk transfer or a risk compensation in return for the payment of a premium and compensation for the risks in accordance with the laws of statistics. In addition, neither the offering of parts of the core functions to third parties nor making necessary support functions available to third parties will put FINMA's supervision in jeopardy. Therefore, the offering of core functions and necessary support functions to third parties without a risk component or, respectively, an insurance as such (see with regard to the term Section 3)a) above) constitutes in our view insurance business.

4) Ways for Insurers to Operate Non-Insurance Business

As mentioned, it is crucial for insurers to leverage new opportunities and to build more stable and resilient business cases. Article 11 ISA does not *per se* prevent such activities, albeit it being applied too restrictively in practice. There are ways for insurers – some of them being explicitly supported by the legislator and FINMA (see Section 4) b) below) – to conduct non-insurance business in a permissible way.

a) Applying for an Exemption Permit

FINMA may authorize the operation of non-insurance business if it does not jeopardize the interests of insured persons (article 11(2) ISA). FINMA has discretion in assessing the application and usually grants a permit to conduct non-insurance business in exceptional cases only, *i.e.*, where the risks are minor, the relevant business activities are of limited scope, no additional solvency risks occur, and the supervision of the non-insurance business is considered manageable. FINMA usually also asks for a plausible justification for operating the non-insurance business.

Non-insurance business does not *per se* jeopardize the interests of the insured persons. On the contrary, non-insurance business supports insurers in diversifying their revenue streams which leads to the diversification of traditional insurance business risks and cycles and helps to bolster the insurer's capital base. In addition, non-insurance business can be less risky than the insurance business as such given that it does not intrinsically give rise to potential future claims. Furthermore, potential claims arising out of non-insurance business activities may even be better manageable than those arising out of insurance business which bases on fortuity. Thus, non-insurance business does not necessarily have a negative impact on the Swiss Solvency Test (SST), but rather helps to increase the relevant SST ratio due to diversification and non-risk revenue streams. We are of the view that FINMA should include these considerations when assessing an insurer's application to operate non-insurance business.

This approach would also be in line with the intention of the Swiss Federal Council to promote innovative business models and to thereby enhance the future competitiveness of the Swiss insurance sector.

b) Non-Insurance Business Operated by a Subsidiary

The (direct or indirect) holding of companies that solely conduct non-insurance business is not subject to article 11(1) ISA. Consequently, a direct or indirect subsidiary of an insurer can conduct non-insurance business without FINMA approval (see Dispatch of the Swiss Federal Council on the Insurance Supervision Act and the Amendments to the Insurance Contract Act of 9 May 2003, BBl 2003 3789 *et seqq.*, 3793). Based on the individual case, a notification on participating interests according to article 21(1) ISA may need to be filed (see Section 5)b) below).

In exceptional cases, the operation of non-insurance business by a subsidiary of an insurer might be problematic. This would be the case if an insurer transfers the non-insurance business to the (direct or indirect) subsidiary only for appearance's sake and in fact conducts the non-insurance business itself. In such a constellation, it may be considered that the insurer violates article 11(1) ISA. Thus, the insurer would need to apply for an exemption permit to operate non-insurance business (see Section 4) a) above). However, in our view, such a circumvention of article 11(1) ISA cannot be easily assumed. To the contrary, specific facts would need to exist proving that the insurer is in fact operating the non-insurance business itself.

c) Non-Insurance Business Operated by a Company of an Insurance Group

Article 11 ISA only applies to insurers. Group companies that do not engage in either direct insurance or reinsurance may conduct non-insurance business without FINMA's approval. Should an insurer transfer the non-insurance business to a group company (which is not a subsidiary) but in fact continues to conduct the non-insurance business, said insurer may be deemed to circumvent and, thus, violate article 11(1) ISA.

5) Reporting Requirements and FINMA's Intervention Possibilities

a) Filing of Amendments to the Insurer's Business Plan

In case the insurer wishes to either directly operate non-insurance business (and to apply for a respective FINMA approval) or have a subsidiary operating it, such insurer must assess whether an amendment to its business plan has to be filed with FINMA.

A potential need to make such a filing may arise out of a necessary change of the articles of association if they do not reflect that the insurer may operate non-insurance business or hold shareholdings in companies operating non-insurance business (*cf.*, article 5(1) ISA in conjunction with article 4(2) lit. a ISA). In addition, it would need to be assessed whether the insurer needs to adjust its organization as a result of directly or indirectly operating non-insurance business (*e.g.*, making changes to the duties of the management, compliance officers or risk management officers) (*cf.*, article 4(2) lit. b ISA). Effectively, this leads to a double approval requirement whereby FINMA has to approve the conduct of the relevant activity as well as the change in the business plan deriving from the conduct of such activity.

b) Notification Duty According to Article 21(1) ISA

If the insurer wishes to conduct non-insurance business through a subsidiary and, to this end, intends to establish a corresponding company or to acquire an interest in or take over a company, the insurer must notify FINMA if the participation reaches or exceeds 10, 20, 33 or 50 percent of the capital or voting rights of such company (article 21(1) ISA). FINMA may prohibit a participation or attach conditions to such participation if the nature and extent of the participation may endanger the insurer or jeopardize the interests of insured persons (article 21(4) ISA). FINMA will usually

conduct a prudential examination and review the capital implications, technical provisions and risk management.

In an insurance group context, FINMA would have to be notified of the intent to create or acquire a significant – determined by FINMA on a group-by-group basis – participation by one of the group companies (article 192(2) ISO).

c) FINMA's Intervention Instruments

FINMA has extensive powers of intervention under the ISA and may take measures if it deems the interests of the insured persons to be at risk (article 51(1) ISA). FINMA may take measures in individual cases even if the non-insurance business is operated by a subsidiary of an insurer and FINMA reaches the conclusion that such subsidiary poses risks to the insurer and the insured persons. However, in our opinion, FINMA should generally abstain from intervening in connection with non-insurance business operated by subsidiaries of insurers. Article 51(1) ISA is not a backdoor for a *de facto* ban on the indirect operation of non-insurance business.

In addition, group supervision does not provide FINMA with any instruments to intervene directly with the relevant group company.

6) Conclusion

Although contested and in some ways overly restrictive, current indicators point to the fact that the revised Insurance Supervision Act will continue to prohibit the operation of non-insurance business by insurers in the future. Insurers do not act in a protected bubble, but are facing the challenges of our time to the same extent – or even to a greater extent – as all other market players. Societal megatrends, technological developments and new competitors force insurers to reinvent themselves and to diversify their revenue streams. In addition, insurers will continue to digitize their value chain and to provide digital services and solutions to their customers (*e.g.*, website platforms, mobile device applications). Therefore, it is in our view important to create a level playing field with respect to innovative business models for both regulated and non-regulated market players such as technology companies (*e.g.*, Alibaba, Alphabet, Microsoft). Furthermore, the current regulatory approach pursued in practice tends to push insurers into dependency with technology companies.

While FINMA as regulator should guarantee a stable and well-functioning insurance market, it should at the same time also support insurers in adapting to the aforementioned new realities. One way to facilitate such support is to interpret article 11(1) ISA less restrictively by taking on a broader view considering the principle of the solvency- and risk-based, proportional insurance supervision. Another way to support the insurers would be to more generously grant exemption permits, a change which might come along with the revised ISA.

The risks associated with innovative business models not constituting traditional insurance business may in certain cases be comparable to risks which an insurer already or likely very soon will be exposed to in connection with the digitalization of its business processes. Hence, FINMA will have to become familiar with those kinds of risks any way, which in turn means that FINMA will also be capable of supervising risks arising out of innovative non-insurance business models. As a result, it could no longer be argued that innovative non-insurance business models can in fact not be properly assessed and supervised by FINMA.

This more liberal approach would also be in line with the Swiss Federal Council's explicit desire to promote the competitiveness of the Swiss insurance sector. Albeit it being expected that insurers will be restricted to operate non-insurance business in the future, it is important for them to know that there are ways to structure the operation of non-insurance business in a legally permissible manner and to thereby support them in their efforts to maintain future competitiveness.

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LIBOR transition remains fraught with risk

Reference: CapLaw-2021-32

Publication of most LIBOR rates will be discontinued at the end of this year. The effects on financial contracts, which refer to a discontinued LIBOR rate to determine a payment obligation and which have a term that runs beyond discontinuation, are unclear and may depend on the facts surrounding the individual contract. Legislators in key interbank markets have adopted or are in the process of adopting legislation governing LIBOR discontinuation and its legal effect on affected contracts. Switzerland is not adopting such legislation. As a consequence, the situation of parties to affected contracts governed by Swiss law remains unclear, and both sides are exposed to significant (litigation) risk.

By Thomas Werlen / Jonas Hertner / Dusan Ivanovic

1) Introduction

After almost four decades of playing a prominent and essential role in financial markets worldwide, the London Inter-bank Offered Rate ("**LIBOR**") is coming to an end: in December 2021, most of the LIBOR rates will either cease to be published (all CHF and EUR LIBOR settings as well as certain USD and most GBP LIBOR and JPY LIBOR settings) or be published on a "synthetic" basis, i.e. based on a changed methodology (certain GBP and JPY LIBOR settings). For certain USD LIBOR settings,

the date of discontinuation has been pushed back to end of 2023, allowing parties more time to adjust.

The discontinuation of these popular reference rates is a consequence of widespread LIBOR manipulations and a significant decline in interbank market liquidity. Regulators around the globe reached the view that LIBOR rates should make way for alternative benchmark rates. Following recommendations by the Financial Stability Board in 2014, national working groups in the relevant markets started developing and identifying successor "risk-free" benchmark rates. These efforts further accelerated in 2017, when Andrew Bailey – then chairman of the UK Financial Conduct Authority – announced the *de facto* end of the LIBOR at the end of 2021.

The transition from LIBOR to alternative, risk-free reference rates is not set to be risk-free itself. In fact, market participants, industry experts and global regulators are expecting waves of litigation arising from disputes regarding *tough legacy contracts* – contracts which refer to a LIBOR rate, have a term extending beyond discontinuation and do not contain provisions governing the legal effects of discontinuation. Michael Held, General Counsel to the New York Federal Reserve Bank went as far as noting that "*This is a DEFCON 1 litigation event if I've ever seen one.*" (https://www.newyorkfed.org/newsevents/speeches/2019/hel190226).

Risk of litigation is expected to be particularly high in jurisdictions that do not provide for statutory fallback scenarios, and in situations where one party to a LIBOR-based contract sees itself potentially at a significant financial disadvantage. While certain jurisdictions, notably the State of New York and the EU, have adopted LIBOR discontinuation provisions, and others, such as the UK, are considering doing so, Switzerland is not doing so. This is despite the fact that FINMA, in its "Risk Monitor 2019", has identified the risks stemming from the discontinuation of LIBOR as one of the six principal risks for the Swiss financial center and its participants, and later, in its Guidance 10/2020 regarding the "LIBOR transition roadmap", urged supervised institutions to "*act now*" and take all necessary preparatory actions for the transition.

2) LIBOR discontinuation legislation being adopted in key jurisdictions

A central aspect of LIBOR discontinuation are risks emanating from *tough legacy contracts*. Such contracts are silent regarding the LIBOR discontinuation and therefore will have to be amended, either by mutual agreement of the parties or, in case of dispute, by the court. The present contribution focuses on discontinuation legislation projects in several jurisdictions as well as related aspects under Swiss law specifically (see sec. 3 below).

When LIBOR is discontinued, market participants will face legal uncertainty and adverse economic impacts on thousands of affected financial contracts, including mortgages, loans, business contracts, and securities. To mitigate the risk of economic disruption, the State of New York and the EU have adopted legislation governing the

transition, specifically addressing *tough legacy contracts*. At the same time, the UK is debating a draft law seeking to achieve the same effect.

- In the US, New York State enacted a bill to amend the uniform commercial code and provide for a safe harbor from "*costly and disruptive*" litigation for the use of the benchmark replacement recommended by the Federal Reserve Board, the Federal Reserve Bank of New York or the Alternative Reference Rates Committee and to establish that the replacement is a commercially reasonable substitute for and a commercially substantial equivalent to LIBOR. Parties are prohibited from refusing to perform contractual obligations or declaring a breach of contract as a result of the discontinuance of LIBOR or the use of a replacement (https://legislation.nysenate.gov/pdf/bills/2021/s297).
- In the EU, in February 2021, the European Council amended the EU Benchmark Regulation. The amendments will allow the European Commission to designate statutory successors for affected reference rates. This will include the replacement for the reference rate itself, a spread adjustment as well as further potentially necessary measures. The amended EU Benchmark Regulation entered into force on 13 February 2021 (https://www.consilium.europa.eu/en/press/press-releases/2021/02/02/financial-benchmarks-council-adopts-new-rules-addressing-libor-cessation/).
- In the UK, the legislator is currently debating a proposal for a Financial Services Bill seeking to achieve essentially the same effects and powers for the UK regulator as the EU's amendments to the EU Benchmark Regulation (https://publications.parliament.uk/pa/bills/cbill/58-01/0200/200200.pdf).

All of these legislation efforts specifically address risks emanating from *tough legacy contracts* after legislators recognized that leaving these risks unaddressed creates significant uncertainties for market participants, including retail end-users of LIBOR-based contracts.

3) Switzerland's lack of LIBOR discontinuation legislation leaves the fate of contracts to the parties' ability to find consensus – and to courts

Switzerland has chosen not to introduce LIBOR discontinuation legislation. The "National Working Group on Swiss Franc Reference Rates" ("**NWG**"), which is leading the LIBOR transition efforts in Switzerland operates under the auspices of the Swiss National Bank and provides a forum for regulators and market participants to discuss reference rate-transition developments and issues recommendations to industry participants, has not called for such legislation.

Switzerland's lack of LIBOR discontinuation legislation means that parties to *tough legacy contracts* must find ways to a mutual consensus on the legal effects of the LIBOR discontinuation on their contracts (*cf. para. a) below*). If the parties are unable (or unwilling) to reach consensus, the consequences for individual *tough legacy contracts* remain unclear and largely fact-dependent (*cf. para. b) below*).

a) Parties to tough legacy contracts are well advised to assess their situation and contractual obligations

Following the warning shots by FINMA fired in its Risk Monitors and its Guidances, which set a strict timetable for market participants to achieve transition milestones, banks have begun reaching out to counterparties. With respect to non-bank, end-user counterparties, these efforts typically consist in asking counterparties to agree to amendments to incorporate an alternative reference rate as a fallback rate in the event of LIBOR discontinuation. FINMA urged banks to reach out to affected counterparties by end of March 2021, and most counterparties will have received such correspondence from their bank by now.

In an evaluation of self-assessment questionnaires completed by banks, FINMA found that the greatest portion of affected contracts are OTC derivatives, followed by credit agreements. Both types of contracts to a large extent use standardized documentation (standard language, model agreements). While the loan market is dominated by bank-proprietary standard agreements, in the OTC derivatives market the use of industry-wide highly standardized master agreements prevails (i.e. the 1992 and 2002 ISDA Master Agreement by the *International Swap Dealers Association* ["**ISDA**"] and the 2003 and 2013 Swiss Master Agreements ["**SMA**"] by *SwissBanking*).

Under the 1992 and 2002 ISDA Master Agreement, the 2006 ISDA Definitions are relevant for LIBOR-linked derivatives. As of 25 January 2021, a fallback mechanism has been added to these definitions, which will henceforth apply to derivatives transactions that refer to the 2006 ISDA Definitions. Furthermore, ISDA provides the ISDA IBOR Fallback Protocol. These precautionary actions, coupled with the fact that ISDA Master Agreements are governed by either English or New York law, which already have or will have LIBOR discontinuation legislation, mean that risks arising from legacy contracts will largely be mitigated.

The situation is quite different for contracts governed by Swiss law, including contracts entered into under the SMA. SwissBanking has published its own model Amendment Agreement on Reference Rates as well as Supplementary Definitions on Interest Rate Derivatives, Reference Rates and EONIA to a Swiss Master Agreement for OTC Derivatives (2003 and 2013) which may be agreed upon by parties to derivatives contracts. In the event that parties are unable to reach a consensus, there will not be a statutory fallback position.

As a result, it is advisable for parties to *tough legacy contracts*, in particular if the contract is governed by Swiss law, to consider their position carefully before signing amendments suggested by banks. There may be scenarios, in particular in light of the negative interest rate situation, where parties may prefer to reassess their benchmark rate-referenced contracts as a whole to avoid significant uncertainties and potential losses.

b) Potential scenarios under Swiss law in case of dispute

While it is advisable to strive for a consensual solution, parties to a *tough legacy contract* under Swiss law may fail to reach an agreement on the legal effects of the discontinuation of the referenced rate. Such scenario, as feared by European and US regulators and legislators alike, may arise when the parties disagree on the replacement rate, or even whether or not the contract shall continue. In such a case, the fate of the t*ough legacy contract* may end up being determined in the courtroom.

Again, *tough legacy contracts* are characterized by the fact that they do not account for an answer to the question "what happens if the reference rate ceases to exist?" In case of a dispute, the answer shall be given by the court pursuant to the established rules of contract interpretation and amendment.

Accordingly, when interpreting the terms of a *tough legacy contract*, the court will – as a starting point – consider the contract's wording, which may be inconclusive. The court will then assess the circumstances under which the contract was concluded, i.e. the negotiations of the parties, the purpose of the agreement or the time of the conclusion of the contract. To what extent a dispute may be resolved through the means of interpretation is going to be determined on a case by case basis.

The court may find that the *tough legacy contract* cannot be cured by contract interpretation – in such a case the court may amend the *tough legacy contract* applying non-mandatory law and the hypothetical intent of the parties. The amendment of *tough legacy contracts*, too, will depend on the facts of each case (and – for that matter – the evidence presented by the parties). Whether or not some non-mandatory rules such as art. 314(1) of the Swiss code of obligations ("**CO**") are applicable to LIBOR loans is unclear, and legal doctrine is inconclusive.

The discontinuation of LIBOR is – as evidenced by the legislative efforts in the US, the EU and in the UK – an extraordinary event, comparable in its impact to the introduction of the EURO and the replacement of the European predecessor currencies. Swiss law provides for certain provisions which address such extraordinary events and form exceptions to the *pacta sunt servanda* principle.

A court may find that LIBOR discontinuation leads to an impossibility to perform pursuant to art. 119 CO. A court may also find that discontinuation leads to a situation

that is fundamentally different such that it allows parties to terminate the *tough legacy contract* extraordinarily on the basis of *clausula rebus sic stantibus*.

A court may also find based on the circumstances that the parties had an intent to replace the LIBOR with a successor rate and the *tough legacy contract* can continue to be performed. In such a case, the sole risk is lengthy and costly proceedings. However, if any of the (rather "high risk") scenarios described above applies, the parties will not only lose time and money on the proceedings but also possibly on the merits. That such "high risk" scenarios are not only of theoretical nature is, yet again, evidenced by the EU and New York legislation, experts' statements and lastly the alerts by FINMA. Against that background, parties will generally want to reach a consensual solution.

4. Conclusion and recommendations

LIBOR discontinuation creates significant uncertainties for parties to *tough legacy contracts*. In jurisdictions with specific LIBOR discontinuation legislation risks emanating from these uncertainties are significantly lower than in jurisdiction without a statutory fallback position, such as Switzerland.

In Switzerland, affected parties who cannot agree on the legal consequences of the (now impending) LIBOR discontinuation may be heading for court proceedings with an unclear outcome. In the extreme scenario it is conceivable that the originally agreed (monetary) consideration may no longer be due.

In order to assess the legal risks, it is therefore imperative to analyze the existing stock of LIBOR-related contracts including the circumstances surrounding the conclusion of these contracts and the documentation, in order to prepare for (re-)negotiations or possible civil proceedings.

Where possible contractual amendments should be sought based on consent of the parties involved, such as the transfer of LIBOR contracts into fixed-rate agreements or a termination by mutual consent, and in the words of FINMA in its "Risk Monitor 2020": "*there is no time to lose*". At the same time, parties should however not rush into such amendments without a careful assessment of their risks (or opportunities).

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Reverse Factoring: Growing Spot on the Radar of Capital Market Transactions

Reference: CapLaw-2021-33

The Greensill case and other recent corporate breakdowns have turned the spotlight on the risk of supply chain finance. Since the outbreak of COVID-19, demand for supply chain finance has soared. The main concern is a lack of transparency. The implications of supply chain finance on capital market transactions are highlighted in this article.

By Ralph Malacrida

1) Supply Chain Financing

Companies are focused on access to capital during times of economic uncertainty. As a result of the COVID-19 pandemic, issuers have aimed at strengthening the balance sheet and improving the liquidity management. One way to manage liquidity is by focusing on payments to suppliers. Various supply chain finance solutions exist. An increasingly popular method involves what is commonly referred to as "reverse factoring".

a) Reverse Factoring

In a conventional factoring arrangement, a company sells its accounts receivable, i.e. unpaid invoices sent to customers, to a factoring company. By contrast, in a *reverse factoring* transaction, a company transfers its *accounts payable, i.e. the invoices it receives from manufacturers or wholesalers*, to a financial institution, which intermediates the accounts payable process at the debtor's behest.

The financial institution pays the debtor's bills to the suppliers upfront so that the suppliers can immediately cash in the money at a small discount. The debtor then pays the financial institution back in full over time. The financial institution may also package the debt into securities and sell the securities to investors or funds, as with any other asset class. Thus, the money raised from investors is used to pay the debtor's suppliers. The discount (less the financial institution's take) represents the investors' return. Securities that are wrapped up in a fund and sold to investors are usually backed by credit insurance.

Therefore, reverse factoring solutions give companies access to funding that may not be available otherwise and allow (large) companies to negotiate extended payment terms with suppliers, while the suppliers get paid on time or early against a small fee. This way some debtors have pushed out payment terms for substantial periods of time, from 30 to 60 days in the past to 180 or 210 or even 365 days subject to a reverse factoring arrangement.

b) Commercial Risks

Reverse factoring optimizes cash flows and reduces working capital needs. This is legitimate to increase a company's financial sustainability. The issue is that the company's delayed payment obligation to the financial institution or the investors of securitized products can have the commercial effect of borrowing and be equivalent to obtaining a credit or issuing a bond.

Nevertheless, reverse factoring liabilities are mostly classified as 'trade payables' or 'other payables' with at best some disclosure in the notes. This may provide insufficient information of the technique's impact on a company's financial position. The effect of reverse factoring can consist in reducing the company's reported debt and improving the return on capital employed, impacting debt covenants (debt-to-equity ratio and credit utilization ratio) and triggering vesting conditions for employee incentives (if executives are held to a working capital improvement target).

In addition, the disruption to the worldwide economy due to the COVID-19 crisis has exposed reverse factoring as a liquidity risk, even though one of its main purposes is to deal with liquidity needs efficiently. If a company goes down the route of supply chain financing, but then suddenly interrupts the process, mostly involuntarily because supply chain finance providers have tightened credit terms or credit insurers have refused the renewal of insurance policies, it may end up with a cash flow squeeze at a time when sufficient liquidity would be paramount.

These issues have come to the forefront in a number of high-profile cases gone awry in the recent past, such as the U.K.'s largest bankruptcy case involving Carillion, the construction company collapsing in 2018. It had labelled debt of GBP 500 million as "other payables". Abengoa, the Spanish clean energy business, and the United Arab Emirates' NMC health care provider represent other prominent cases where reverse factoring resulted in forced liquidation. The latest case in point is the demise of Greensill Capital, a financial services company focusing on the provision of supply chain financing and the securitization of the related asset class. Greensill Capital was supposedly headed for a large IPO before imploding when a required insurance policy lapsed and the insurer refused to renew it.

Rating agencies have been warning about the high, but hidden, risks of reverse factoring for some time, pointing out that the goal of transparency could be achieved by re-classifying any payment extension related to a reverse factoring transaction as financial debt on the balance sheet and the related cash flow movements as cash flows from financing.

In addition, reverse factoring has been on the agenda of the International Accounting Standards Board for the purpose of discussing the adequacy of the existing IFRS accounting standards (https://ifrs.org/projects/completed-projects/2020/supply-chain-financing-arrangements-reverse-factoring/; last accessed on 18 April 2021).

c) Legal Implications

Under certain circumstances reverse factoring can result in sudden and significant working capital outflow and financial distress. This is because of the short-term nature of supply chain finance agreements involving the risk of providers pulling facilities and not renewing them. As a result of this, financial covenants in other finance arrangements may be breached, events of default may occur, and/or liquidity squeezes may arise. In consequence, share and bond prices may collapse and insolvency may loom.

Financial covenants in credit facilities and terms of high yield bonds serve the purpose of providing a safety net for the finance provider. If a reverse factoring scenario results in the breach of a financial covenant, such breach gives the finance providers the right to ask for immediate repayment, collect collateral, or charge a higher interest rate.

If the financial distress of an issuer is such that it is generally unable to meet its financial obligations to creditors as debts become due, the issuer is insolvent and must file for bankruptcy.

In scenarios where share or bond prices collapse or issuers become insolvent, the investors and/or finance providers will seek ways to recover part of their damage. Against the backdrop of a recent capital market transaction, the most likely remedy would be a lawsuit on the grounds of prospectus liability.

2) Relevance for Capital Market Offerings

a) Swiss Prospectus Liability Regime

Under the old prospects liability regime of article 752 of the Swiss Code of Obligations (CO), each person that was involved in the drafting or distribution of an offering document containing incorrect, misleading or legally insufficient information was liable to the investors for any damage caused as a result of it. According to the Swiss Supreme Court, however, each party involved in a capital market transaction could rely on the advice of experts, such as lawyers or auditors, provided that there was no reason to assume a lack of diligence on their part or any other ground to be concerned requiring closer examination. Moreover, the Supreme Court pointed out that as a rule the underwriters had a duty to verify statements only if they were made by the issuer as opposed to third party experts (BGE 129 III 71, 75 f.).

The new Swiss prospectus regime under the Financial Services Act (FinSA), on the one hand, has expanded its scope of application, now including secondary offerings, disclosure for derivatives transactions, and criminal liability for willful breaches. Article 69 FinSA states that whoever fails to exercise due care and therefore makes inaccurate or misleading statements or statements that fail to comply with statutory requirements in prospectuses, key information documents or similar communications is liable to the purchaser of a financial instrument for any loss caused. On the other hand, the FinSA prospectus regime has limited the standing to be sued on the grounds of

prospectus liability to whoever *makes statements* in an offering document, as opposed to those who are assisting in the drafting or distribution of a document. In addition, each prospectus must indicate who is responsible for which part of it (as set out in article 4 of Annexes 1 - 5 of the Financial Services Ordinance). Therefore, legal scholars have pointed out that investors should be able to sue only the person taking responsibility in the prospectus, which in practice would be the issuer.

In consequence, the issuer's directors and managers, outside legal and tax counsels, accountants, and underwriting banks would no longer be liable to investors that suffer a damage because they relied on an incorrect or misleading prospectus. This notwithstanding, the issuer may have recourse against these participants in a capital market offering. Underwriters as well as legal and tax counsels will continue to be liable for breach of due care in relation to their contractual obligations to the issuer (based on article 398 CO), whilst other participants may be liable to the issuer – or the investors in the event of the issuer's insolvency – on the grounds of statutory law, such as the issuer's directors and managers (based on article 754 CO) and the audit firms if the audited financial statements included in the offering documents are incorrect (based on article 755 CO).

Would investors that have suffered a damage as a result of reverse factoring of an issuer, be likely to succeed with a claim on the grounds of prospectus liability?

b) Prospectus Liability Due to Reverse Factoring?

For the reasons set out below claims of investors related to reverse factoring are prone to fall between the cracks of both the old and the new prospectus liability regime.

Issuers applying supply chain financing are acting in the interests of the company by reducing working capital needs. Assuming that issuers comply with the applicable accounting and disclosure rules, it will be difficult to prove a lack of diligence on their part when it comes to (theoretical) future risks related to reverse factoring, which does not have to be accounted for as debt.

Underwriters will assume that due diligence investigations related to reverse factoring fall within the responsibility of the experts, be it the accountants when it comes to the appropriate financial disclosure in the accounts or the lawyers concerning the qualification of reverse factoring in relation to financial indebtedness and compliance with debt covenants in existing finance documents.

From the auditor's perspective, the issuer's decision not to record financial debt and cash flows from financing related to reverse factoring, will be in line with the (existing) accounting principles so that accountants will not red-flag reverse factoring due to its risk of being similar to undisclosed debt.

From a legal perspective, the question how an entity presents liabilities to pay for received goods or services is not a contractual, legal or regulatory risk as long as the issuer's approach complies with the accounting rules. If invoices are part of a reverse factoring arrangement, lawyers will assume that any relevant financial information is required to be disclosed in the financial statements.

Hence, the highlighting of potential risks related to specific facts of reverse factoring in any particular case may lay outside the responsibility of the issuer and outside the fields of expertise for which the underwriters, auditors or lawyers would (need to) feel responsible. As of today, though, in the absence of a body of court precedents the risk exists that a Swiss court may take a sterner view of issuers dealing with liquidity strains by opting for reverse factoring without ample disclosure.

c) Due Diligence

The purpose of conducting due diligence is varied but always includes the aim to establish a defense for the parties drafting an offering document. Especially the underwriters seek the assistance of outside counsels and advisors to establish the proof for reasonable grounds to believe that there is no misrepresentation or misleading statement or omission in a prospectus.

Despite the recent change of the Swiss prospectus regime, it is safe to assume that the standard of diligence applying to underwriters as laid down by the Supreme Court will continue to apply, irrespective of whether the underwriters are liable to the investors directly or only to the issuer (or, in a worst case scenario, the issuer's bankruptcy estate).

Therefore, the adage is still valid that due diligence by experts and disclosure in the offering document are effective antidotes to prospectus liability, also as far as reverse factoring is concerned.

Even though reverse factoring has been recognized as a potential issue when it comes to undisclosed financial risks, the situation will not be remedied in the short term in the absence of tighter accounting regulation and greater transparency requirements for supply chain finance. Recently, the IFRS interpretations committee concluded that the existing principles of IFRS standards and requirements provide an adequate basis to present liabilities and the related cash flows, and to disclose risks arising due to such arrangements in the notes, albeit a possible narrow-scope standard-setting project to develop specific disclosure requirements will be discussed in 2021 (see IFRS decision published on 14 December 2020; https://ifrs.org/content/dam/ifrs/project/supply-chain-financing-arrangements/supply-chain-financing-arrangements-reverse-factoring-december-2020.pdf); last accessed on 18 April 2021). Issuers will therefore need to apply judgement and consider the facts and circumstances when determining the appropriate impact of reverse factoring on their financial statements and financial sustainability in general.

Based on this, when it comes to due diligence in capital market transactions, reverse factoring arrangements should be generally characterized as potential red flags on the list of questions that the underwriters prepare with the assistance of their legal counsels. In addition, responsibilities need to be clearly communicated and documented at the outset of each due diligence investigation.

It may be difficult in any given case of trade finance to implement a clear distinction as either debt or accounts payable. Therefore, the matter may have to be investigated through more enhanced due diligence during management meetings and auditor diligence with the aim of eliciting assessments from the issuer on the immediate, ongoing and future impact of possible disruptions due to reverse factoring arrangements. When performing documentary due diligence, one telltale sign of reverse factoring is a jump in the line item "accounts payable" or "other payables" of a company's balance sheet. This is where the debt may hide that a company may have created by entering into reverse factoring agreements.

Given the rating agencies' insistent warnings in relation to reverse factoring, when drafting the offering document it will also be crucial to read the credit rating agencies' commentary on the issuer, potentially including useful information on supply chain financing.

d) Disclosure

Once the impact of reverse factoring on the issuer has been ascertained, the disclosure and risk factors in the offering document should reflect the due diligence results and provide investors with an accurate assessment of the situation.

Swiss law and regulators generally require the inclusion of risk disclosure statements in offering documents, but remain silent on the precise scope. By contrast, some international regulators have been explicit and highlight the need for robust disclosure in offering documents specifically as to potential effects of COVID-19 on matters related to supply chains and liquidity (see e.g. SEC disclosure guidance; topic no. 9A; 23June 2020; https://www.sec.gov/corpfin/covid-19-disclosure-considerations; last accessed on 18 April 2021). They highlight the importance of robust and transparent disclosures of how companies are dealing with short- and long-term liquidity and funding risks in the current economic environment, particularly to the extent efforts present new risks or uncertainties to their businesses.

Moreover, in the face of a general trend in international capital markets towards more and better disclosure, careful consideration should be given, and discussions should be held between the issuer and advisers, as to whether supply chain financing may warrant a separate risk factor or, in light of its potential materiality, require information to be included in the MD&A section of an offering document.

These days, in response to the effects of COVID-19, issuers have obtained and utilized (government supported) credit facilities, accessed public and private markets, implemented supplier finance programs, and negotiated new or modified customer payment terms. Thus, they have spun a complex web of finance transactions that complicate the analysis of financial statements. As a result of this, now more than ever, in preparing offering documents issuers, underwriters, counsels and auditors need to cut to the chase of financial risks and disclose what really matters to the investors, including, in particular, reverse factoring.

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Ad Hoc Publicity – New Rules And Their Consequences For SIX Listed Issuers

Reference: CapLaw-2021-34

As of 1 July 2021, SIX Exchange Regulation Ltd (**SER**), the supervisory authority for issuers listed at SIX Swiss Exchange (**SIX**), revises the rules on ad hoc publicity in the Listing Rules (**LR**) and the Directive on Ad hoc Publicity (**DAH**). While the changes might not seem substantial at first, some details of the revised provisions are delicate, and issuers should carefully consider some practical consequences when releasing information in the future. The following article contains an overview of the changed provisions, including an initial assessment of their consequences.

By Andrea Rüttimann

1) Flagging

In a game-changing approach, SER provides that media releases containing price-sensitive information must explicitly be qualified and labeled as "ad hoc". Issuers must flag such releases in a clearly recognizable manner as "*Ad hoc announcement pursuant to Art. 53 LR*" (art. 53 para. 2bis LR and art. 7 DAH). If a media release *obviously* contains no price-sensitive information, the announcement must not be flagged. Flagging is in line with the rules in many EU jurisdictions. For SIX primary listed issuers, however, the new approach requires a re-assessment of how to publicly releasing company information.

SER emphasizes in this context the discretion of issuers when qualifying the price sensitivity of its information (cf. Issuers Committee Circular No. 1 – Revised provisions in the area of ad hoc publicity and corporate governance of 10 March 2021, note 13 (**IC-CIR1**)). It, however, also clearly states that misuse of flagging can be sanctioned. As an example, SIX illustrates that qualifying a pure marketing press release as ad hoc is not permitted.

In practice, there exist two possibilities where issuers run the risk of being in violation with this new obligation:

First, "over-flagging", i.e. to flag a release, which may not necessarily contain price-sensitive information. Indeed, this should be not so much of an issue, given (i) the admittedly large discretion of the issuers (cf. paragraph above) (ii) the *ex ante*-view, (iii) the somewhat open definition of price-sensitivity as well as (iv) the lack of damage by too much information. Apart from blatant abuses or constant over-flagging by an issuer, market transparency and market participant's interests will hardly suffer from an "over-flagged" release. These are reasons SER should keep in mind whenever challenging the qualification of an issuer; otherwise the cautious might be punished.

Secondly and more delicate, if SER challenges an issuer's decision not to flag a release. As a precaution (and simple solution), issuers could be tempted to widely flag media releases as "ad hoc". However, flagging should be thought through carefully. First and most importantly, the flagging requires prior assessment by the issuer. With its communication practice the issuer will set a certain standard by which the issuer's assessment will be judged by the market (and SER) in similar situations in the future. If, for example, a certain deviation in a KPI is qualified as price-sensitive, the issuer will, *ceteris paribus*, be bound to assess a comparable deviation in a comparable KPI in the future in the same way. The issuers' discretion can thus be substantially limited through a low threshold when qualifying price-sensitivity. On top, a flagged release will draw more attention (e.g. a flagged outcome of a clinical trial). Market participants will interpret information differently with the implicit label "price-sensitive". To "flag" a release could thus even be price-sensitive information in of itself because the act of "flagging" is a direct statement of the issuer that the information contained in the release is relevant for the valuation of the market price. While this assessment was generally left to analysts or market participants under the current system, it is now – to some part at least – on the issuer under the new regime. Issuers will thus have greater responsibility for their media releases.

The assessment gets even more complicated for media releases that contain a mix of topics (e.g. bad news brightened up with good news, several changes in senior management positions on different levels, trading update combined with another topic) as it is common practice. Some of the information contained therein might be price-sensitive, some not. SER does not give indications in their explanations that a mixed topic release would not be allowed. From the considerations above, it follows that such a release must be flagged because it contains price-sensitive information at least in some parts. This, however, might result in the not price-sensitive information also contained in the release being considered in a different, maybe non-desirable light. Issuers might thus even consider publishing two media releases at once, one strictly limited to the price-sensitive fact and one with the rest of the news – like it is practiced by issuers in some EU jurisdictions.

Some issuers will have to answer these questions soon after the entry into force of the new rules. For the majority of issuers the half-year results trickle in during July and, provided that these half-year results deviate from the ones in 2020, the issuers have to answer the question whether they have to issue a profit hike/loss or profit warning prior to the release of the 2021 half-year report. Looking at the corporate communications of SIX listed issuers so far, the results for half-year 2021 might be substantially better than 2020 (maybe even back to the level of 2019). Very generally speaking, the deviations will, to some extent, be the economic consequence of the pandemic in 2020 as well as the economic rebound in 2021. This, however, should be a commonly known fact to a reasonable market participant and, hence, should not qualify as price-sensitive. It is unclear though whether SER shares this view. Thus, issuers – and in particular issuers who do not report quarterly and/or have not yet released information on their (expected) 2021 financial results – will have to carefully assess (i) whether or to what extent their 2021 results are the consequence of the pandemic and (ii) whether or to what extent this could have been expected by the reasonable market participant (see for the new term below, A.V). As is often the case, there is no general rule and a case-by-case analysis will be necessary.

Furthermore and as a side note only, where a sanction proceeding is initiated by SIX (e.g. for delayed release), the issuer's qualification as "ad hoc", must not lead to a reversion of the burden of proof. Whether or not a specific information is qualified price-sensitive *in a legal proceeding* will always be decided on the merits of the specific case and not based on a qualification made by the issuer in an ex ante-view.

Additionally, as of 1 July 2021, issuers have to re-organize their website and separate ad hoc announcements from other media releases (by a separate directory or by installing a filter function). According to SER, ad hoc announcements must be made available in chronological order in an easy-to-find directory that indicates the date of distribution and the classification as "ad hoc" (art. 9 para. 1 DAH). Releases issued prior to 1 July 2021 will not have to be classified ex post. The ad hoc announcements will have to be made available for a period of three years after publication (as opposed to two years under the current rules). As a consequence of the flagging, the number of ad hoc releases will likely diminish in the future compared to the number under the current system.

2) No "per se" facts except Financial Reports

In a welcome change, and conceding to the longstanding critics in legal literature, SER shifts and gives up its practice of the so-called "per se" facts, which have to be published by means of an ad hoc announcement regardless of the specific circumstances of the case (art. 4 para. 2 DAH). Financial reports pursuant to art. 49 and 50 LR, however, since they are of importance for the valuation of the company, are always qualified as price-sensitive.

This shift has its biggest impact when it comes to changes in the issuer's board of directors and executive committees. So far, issuers had no discretion, as such changes were considered price-sensitive per se. The practical consequences of the shift will be limited, though. With the assessment to flag or not to flag an executive change (or flag, for example, only for the CEO and Chairman), the issuer also here sets a certain standard that has to be maintained in following situations. Issuers will however have the discretion to develop their own communication practice.

In the aftermath of the Ordinance Against Excessive Remuneration (**OaEC**) many issuers have reduced the number of members in their executive committees to the main business functions – where a change might arguably be more important. Some issuers might thus simply continue the present practice and release every executive change by means of an ad hoc announcement, be it for practical reasons or for personal sensitivities.

3) Postponement of Disclosure

With the instrument of the postponement of disclosure, an issuer may hold back the release of a price-sensitive information, provided, *inter alia*, that the confidentiality of the information is guaranteed. SER has now somewhat strengthened the requirements for the prerequisite of confidentiality. New art. 54 para. 2 LR provides that issuers must guarantee *by means of adequate and transparent internal rules or processes* that confidentiality can be maintained throughout the duration of the postponement. The issuer must now *take additional organizational measures* to ensure that confidential facts are *only disclosed to persons who need them to perform the tasks assigned to them* (emphasizes by the author).

SER writes that issuers are in general free to choose the organizational methods and instruments for ensuring confidentiality, but have to consider "best practice" in this regard. SER further states that "best practice" may include: (i) limiting the number of people who know the information to the smallest possible number ("need-to-know" principle), (ii) limiting and safeguarding access to information, (iii) confidentiality declarations from all people who know the information, both internal and external, and (iv) maintaining a list of insiders (IC-CIR1, note 17). Some of these measures are already part of the statutory requirements to prevent insider trading according to art. 128 FMIO and it probably makes sense to align the ad hoc rules accordingly. Elsewhere, in the context of the issuers' discretion, SER again emphasizes the importance of proper internal rules and procedures (IC-CIR 1, note 7), i.e. with proper internal disclosure and insider trading policies. It is thus doable and also recommended that issuers implement (and stick) to the measures proposed by SER (even though they cannot be sanctioned if not).

4) Disclosure of Blackout periods

In an amendment not strictly related to ad hoc publicity, but that will be useful for market participants, the corporate governance sections of annual reports must now contain a generic description of the *general* quiet periods ("blackout periods"), e.g. deadlines, recipients, scope and exceptions (Annex 1, cif. 10 of the Directive on Information relating to Corporate Governance, DCG). As always, the principle of comply or explain is applicable. Whereas one-time quiet periods (e.g. during a postponement of disclosure) must not be disclosed in the hindsight. Blackout periods show the timeframes when assumedly insider information respectively price-sensitive information exists and, hence, not all available information is priced into the market price. To know about this timeframe can be a relevant information for a market participant's investment decision and increases market transparency.

Additionally, the knowledge about the specific blackout periods of an issuer most likely also facilitates the work of the supervisory authorities (SER, FINMA) when investigating insider-trading violations and, thus, in my view, the amendment also shows the increased interest in enforcing such crimes.

5) More language related Amendments

In addition, the revision sums up what is stated by SIX as being some more language related clarifications. Whether these changes really "do not result in any change in legal practice" (cf. IC-CIR1, note 5), remains to be seen, though.

- In art. 53 para. 1 LR the term "potentially" has been deleted such that only a "price-sensitive fact" remains the triggering event for an ad hoc disclosure. SER holds that the change from "potentially price-sensitive fact" is a clarification of a purely linguistic nature and does not lead to any substantial modification of the term or its legal meaning (IC-CIR 1, note 5). Regardless of the wording, as discussed above, the price-sensitivity is assessed from an *ex ante* perspective. The *ex ante*-view as well as the term sensitivity encompass the *potential* of such information to result in significant market price fluctuations. Moreover, according to its longstanding practice SER does not take into account the actual fluctuations of a market price when assessing price-sensitivity. Consequently, the deletion of "potentially" should really not result in a change in legal practice. In a somewhat unrelated (but important) excursus, SER further states that issuers make their decision using *their discretion, taking into account the company's internal division of responsibilities*. The company's internal division of responsibilities must be based on the company's legal documents, in particular the articles of association, rules of organization, schedule of powers and so forth (IC-CIR 1, note 7; emphasis by the author). If SER follows this, issuers should – to a big extent and subject to abuses – be protected in their discretionary decision, if they comply with their internal regulations provided that these are appropriate.

- As part of an alignment with international standards, the previous term of "average" market participant has been replaced with "reasonable" (art. 53 para. 1bis LR). SER describes a reasonable market participant as person who (i) is familiar with the activity of the issuer and the market of the financial instrument in which this person is making an investment and (ii) who knows the fundamentals of securities trading, corporate law and financial market practices, but does not need to have any special expertise (IC-CIR1, note 9). The description sounds like a strong alignment to the model person of international insider regulation with its "reasonable investor". The question arises whether the first part of the description ("familiar with the activity of the issuer and the financial instrument") results in a higher threshold than what was expected from the "average" market participant under the current rules.

- Thirdly, SER aligns the legal basis in the DAH and the LR in the sense that the principle according to which a fact is considered price-sensitive if its disclosure is capable of triggering a significant change in market prices is transferred from the DAH to art. 53 para. 1 LR. Again as an alignment to insider law (respectively the definition in the FMIA (at least in the German version)), the legal text was also re-worded: from "expected to trigger a price change that is considerably greater than the usual price fluctuations" to "capable of triggering a significant change in market prices".

6) Connexor Reporting

As of 1 October 2021 (not July), issuers of primary listed equities and equity related securities will have to submit their announcements to SIX via the online platform Connexor Reporting, the system so far used, *inter alia*, for regular reporting obligations. Issuers of derivatives, bonds, conversion rights and collective investment schemes can continue to submit ad hoc announcements to SER by e-mail. Connexor will not replace the proper distribution by the issuer according to art. 7 DAH. Some more practical questions of the revision are not yet clear (e.g. time frame for upload, four eyes-requirement). SIX will follow-up with a revised art. 12a DAH and new provisions in the Directive on the Use of the Electronic Reporting Platform to Fulfil Reporting Obligations Under Art. 9 of the Directive on Regular Reporting Obligations (**DRPRO**). Also the Commentary on the Directive on Ad hoc Publicity will likely be revised by the end of 2021.

7) Conclusion

In summary, the new provisions show, first, that SER as the supervisory body for SIX is determined to align its rules and procedures to European standards (see also discussions on stock exchange equivalence) as well as to the provisions of insider trading law. It remains to be seen whether some of the alignments that SER describes as linguistic clarifications will result in a change of practice for ad hoc publicity rules.

For issuers, however, the instantly biggest impact of the new rules will be to *ex ante* qualify the released information as price-sensitive or not and flag such announcements, respectively. In particular, when it comes to financial information, like trading-updates, or other repeating news, issuers have to consider if and if so what communication standard is set with their qualification. In order to defend the qualification, it is key for issuers to have proper internal ad hoc rules and precise procedures already in place.

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Swiss Withholding Tax Reform

Reference: CapLaw-2021-35

The Swiss Federal Council proposes the abolition of withholding tax on bond interest in its dispatch. The proposed abolition will make it easier for companies to issue their bonds from Switzerland. There is also a chance that intra-group financing activities will increase in Switzerland.

By Stefan Oesterhelt / Philippe Gobet

1) Introduction

Under current law, Switzerland levies a withholding tax of 35% on interest payments on bonds (Art. 4(1)(a) Federal Withholding Tax Act ["**WTA**"]) and on bank deposits (Art. 4(1)(d) WTA). In contrast, no withholding tax is levied on interest on individual loans.

The withholding tax on interest makes domestic bonds unattractive for most investors, even if they are entitled to a full refund of the tax. This is problematic for the Swiss debt capital market. In order to avoid the withholding tax, Swiss group of companies today predominantly issue their bonds through a foreign group companies.

In its dispatch, the Federal Council therefore proposes to abolish the withholding tax on bond interest without replacement. This is the consequence of the mixed reactions to the consultation on the Federal Council's proposal of 3 April 2020 to introduce a paying agent tax system on bond interest (see STEFAN OESTERHELT, Federal Council proposal of 3 April 2020 to strengthen the Swiss capital market, CapLaw 2020-41). Although the need for action to strengthen the Swiss debt capital market was generally acknowledged, the paying agent tax system was widely considered too complicated.

The proposed abolition of withholding tax on bond interest makes it easier for companies to issue their bonds from Switzerland, not only for domestic but also for foreign groups. There is also a chance that intra-group financing activities will increase in Switzerland.

Trading in bonds is subject to a transfer stamp duty of 0.15% (domestic bonds) or 0.3% (foreign bonds) if a domestic securities dealer is involved in the transaction as a party or intermediary. In its dispatch of 15 April 2021, the Federal Council proposes to also abolish the transfer stamp duty on domestic bonds without replacement.

The reform leads to estimated revenue shortfalls of just under CHF 200 million per year. If interest rates rise, the revenue shortfall will increase accordingly. However, if the reform achieves to spur domestic capital market and group financing activities, it might have an attractive cost-benefit ratio in the long term.

2) Initial situation and history of origins

The imposition of withholding tax on bond interest makes domestic bonds unattractive for investors domiciled abroad. For this reason, domestic groups of companies issue their bonds predominantly through foreign group companies. If guaranteed by the domestic group parent company, the bonds essentially have the same credit rating as if issued directly by the parent. According to the practice of the Swiss Federal Tax Administration (FTA) of 5 February 2019, the proceeds from such foreign issues may only be on-lent to domestic group companies up to the amount of the equity of the foreign companies (see Stefan Oesterhelt, Swiss Debt Capital Markets: More Flexibility under New Swiss Withholding Tax Rules, CapLaw 2019-44).

Under current law, the only exceptions from withholding tax are regulatory bonds issued by banks (Too-big-to-fail ("**TBTF**") Instruments). Contingent Convertibles (CoCos) and Write-off Bonds have been exempt from withholding tax since 1 March 2012 pursuant to Art. 5(1)(g) WTA. Bail-in Bonds (Total loss-absorbing capacity (TLAC) Bonds) have been exempt from withholding tax since 1 January 2017 pursuant to Art. 5(1)(l) WTA. Both exemptions are limited in time and thus regularly subject to renewal by the Swiss parliament.

The proposed abolition of withholding tax on bond interest puts an end to the Federal Council's long-standing plans to introduce a paying agent tax system. The first such proposal was already launched in 2010 (for an overview of the 2010 proposal of the Federal Council see Dieter Grünblatt and Stefan Oesterhelt, Welcomed Fundamental Changes in Taxation of Debt Instruments Ahead, CapLaw 2011-42). The next attempt was the proposal of the Federal Council of 17 December 2014 following the proposal of the Brunetti expert group (for an overview of the 2014 proposal see Stefan Oesterhelt, Withholding Tax on Interest to be Replaced by Paying Agent Tax System, CapLaw 2015-5). The third proposal to introduce a paying agent tax was launched by the Federal Council on 3 April 2020 (see Stefan Oesterhelt, Federal Council proposal of 3 April 2020 to strengthen the Swiss capital market, CapLaw-2020-41).

3) The Proposal of the Federal Council

a) Proposed legislative changes

The Federal Council is now proposing to completely abolish withholding tax on bond interest. The withholding tax will thus only be retained on interest on customer deposits with banks and insurance companies (Art. 4(1)(a) WTA), dividend income (Art. 4(1)(b) WTA) and income from collective investment schemes (Art. 4(1)(c) WTA). In addition, Art. 4(1)(d) WTA creates a proper legal basis for the levying of withholding tax on manufactured payments for income pursuant to Art. 4(1)(a)-(c) WTA. This affects securities lending in particular (see Section III.E. below).

In addition, the Federal Council also proposes to abolish the transfer stamp duty on domestic bonds. Bonds issued by a foreign company, however, will continue to be subject to the 0.3% transfer stamp duty. The latter also applies to bonds issued by a foreign group company of a Swiss group of companies. This creates a tax incentive to issue bonds domestically in the future.

b) Implications for bonds

Following the abolition of withholding tax on bond interest, domestic groups will probably start issuing their bonds through a domestic group company. However, this will likely not be the group parent company holding the subsidiaries as this would lead to a participation exemption leakage and thus indirect taxation of dividend income.

Example: The listed company of a domestic group (HoldCo) issues bonds in the amount of CHF 2 billion and pays interest of CHF 80 million per year. HoldCo receives dividends of CHF 500 million per year from its subsidiaries. Under the system applied by Switzerland, dividend income is only indirectly exempt. Accordingly, financing expenses (CHF 80 million) must be deducted when calculating the net investment income and the participation exemption is only granted to the extent of 84% (= CHF 420 million / CHF 500 million). Consequently, dividend income in the amount of CHF 80 million is subject to ordinary taxation, which leads to double taxation of dividend income due to the participation exemption leakage. If, on the other hand, the bonds were issued by a subsidiary (without dividend income), such subsidiary could claim a participation exemption of 100% and the dividends would not be taxed.

In order to prevent participation exemption leakage, bonds will probably be issued from a domestic subsidiary that has no dividend income. The situation is only different for banks issuing TBTF Instruments. For regulatory reasons, TBTF Instruments have to be issued by the parent company. The legislator has addressed the participation

exemption leakage arising of this requirement with the provision of Art. 70(6) of the Federal Act on Direct Federal Taxes ("**DBG**") (applicable since 1 January 2019). Pursuant to this provision, financing expenses in relation to TBTF Instruments are disregarded for purposes of the participation exemption.

In the Federal Council's view, these special rules for TBTF Instruments are constitutional. Nevertheless, in the medium to long term, it aims for a similar participation exemption system for all type of companies.

c) Effects on syndicated loan agreements

The abolition of withholding tax on bond interest has implications not only for the debt capital market but also for loan agreements. The term "bond" in the withholding tax law is extremely broad. A financing is considered a "bond" (*Anleihensobligation*) subject to withholding tax if it is syndicated to more than 10 non-bank creditors (so-called 10 non-bank rule). If a domestic debtor has more than 20 non-bank creditors from liabilities denominated in a fixed amount, this further constitutes a debenture (*Kassenobligation*) subject to withholding tax (so-called 20 non-bank rule).

To ensure that interest on credit agreements is not subject to withholding tax, syndications are typically limited to a maximum of 10 non-banks (10 non-bank rule). In addition, domestic debtors must regularly undertake not to have more than 20 non-bank creditors (20 non-bank rule). These restrictions in credit agreements with domestic debtors will cease to apply with the abolition of withholding tax on bond interest.

Having said this, withholding tax on loans secured by domestic real estate is not abolished. Therefore, syndication must be limited to lenders entitled under the provisions of a double taxation treaty to receive interest payments without a tax deduction (so-called Treaty Lenders) whenever a loan is secured by domestic real estate.

d) Customer credit

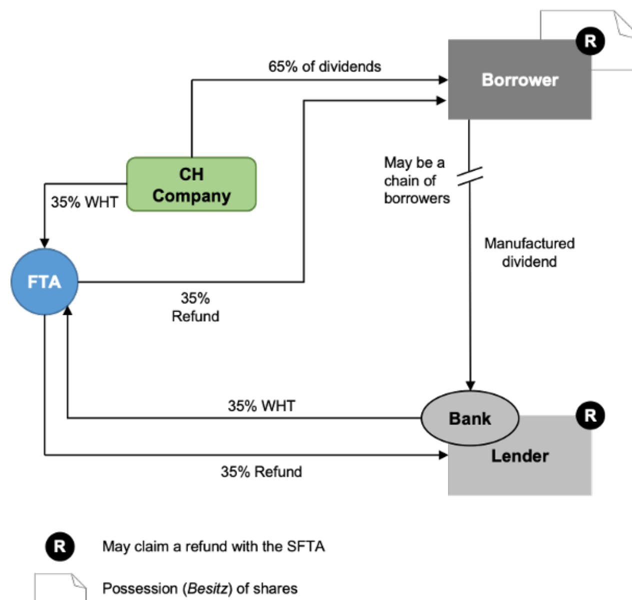
The withholding tax on interest income from the credit balances of individuals resident in Switzerland at banks as well as at insurance companies is retained. Since banks and insurance companies already pay withholding tax on interest from customer deposits, this does not involve any significant increase in complexity. Under the proposed legislation, withholding tax will only be withheld on interest payments to individuals resident in Switzerland. Interest payments to all other investors are exempt from withholding tax.

The scope of application of the withholding tax levied on customer balances will be limited to banks and insurance companies and is thus significantly restricted compared to the current situation. Accordingly, the previously applicable 100 non-bank rule, according to which a domestic debtor is always considered a "bank" for withholding tax purposes if having more than 100 non-bank creditors, will be abolished.

e) Securities lending and borrowing

In the case of securities lending and borrowing, the lender transfers to the borrower the legal ownership of a security (e.g. a share). However, the economic entitlement (beneficial ownership) over the income of the security (e.g. the dividends) remains with the lender. If a dividend subject to withholding tax is due during the loan period, the dividend (so-called original dividend) flows to the current owner of the security (i.e. the borrower). The latter is entitled to a refund of the withholding tax deducted. The borrower must compensate the lender for the lost dividend. This compensation is referred to as a manufactured dividend (*Ersatzzahlung*).

Technically, this is done in such a way that the lender's bank invoices the borrower's bank for the manufactured dividend. According to the current practice, the lender's bank invoices 100% of the proceeds to the borrower. It also pays withholding tax to the tax authorities on the manufactured dividend. The borrower is credited with a manufactured dividend amounting to 65% of the original investment income and is in principle entitled to a refund of the withholding tax.



The current practice in connection with manufactured dividends is based on the principle of multiple withholding tax payments (i.e. on the original dividend and the manufactured dividend) and multiple refunds of withholding tax (i.e. on the original dividend and the manufactured dividend, respectively). This prevents a single levy of withholding tax (on the original dividend) being followed by multiple refunds (on the original dividend and the manufactured dividend).

In its decision of 21 November 2017 (2C_123/2016), the Federal Supreme Court decided that although the previous practice led to an appropriate result, there was no sufficient legal basis for levying withholding tax on the manufactured dividend. This led to uncertainties and risks for the industry and the tax authorities. As a response to this decision of the Federal Supreme Court, the Federal Council proposes to provide for a proper legal basis regarding the withholding tax treatment of manufactured dividends. Under the new proposed legislation, withholding tax is to be levied not only on the original dividend, but on the manufactured dividend too.

f) Cum-Ex transactions

The levying of withholding tax on manufactured dividends affects not only securities lending, but also cum-ex transactions of listed shares. According to industry practice, the transfer of listed shares does not take place until two days (T+2) after the sale. The dividend is credited to the party that has legal ownership of the shares at the due date. Between the sale and the transfer, legal ownership remains with the seller. Settlement takes place almost exclusively via the Central Securities Depository (CSD) or its affiliated banks.

If a dividend becomes due between the sale and the transfer, it is generally credited to the seller. The latter is not the person entitled to the income (time interval between the date of sale and the date of transfer). In such cases, the CSD or its affiliated banks will rescind the proceeds of the seller and credit them to the buyer. This results in both parties to the contract having a receipt with the outcome that a withholding tax refund can be claimed twice. According to the current practice, a second withholding tax therefore is levied by the CSD or its affiliated banks.

This practice is also problematic in light of the Federal Supreme Court's decision of 21 November 2017 (2C_123/2016). The proposed amendment creates a legal basis for the levying of withholding tax which is intended to exclude multiple reclaims of withholding tax.

g) Collective investment vehicles

Income from domestic collective investment vehicles (such as contractual mutual funds, SICAVs or LPs for collective investment) remains subject to withholding tax. The only exceptions are income attributable to direct real estate holdings, capital gains and distributions of capital contribution reserves, provided that these are distributed via a separate coupon.

The Federal Council refrained from an exemption for income attributable to bond interest. Consequently, indirect investments in Swiss bonds via a collective investment scheme are subject to withholding tax while direct investments are not. With respect to

TBTF Instruments held by collective investment schemes, this will result in an extension of the withholding tax.

Since the distribution of interest income from Swiss bonds by domestic collective investment vehicles is subject to income tax for domestic individuals, there is some logic in refraining from an exemption for income attributable to bond interest. On the other hand, it increases the fiscal disadvantage of domestic collective investment vehicles against foreign collective investment vehicles (e.g. a distribution of a Luxembourg fund attributable to interest from Swiss bonds will not be subject to withholding tax, while such distribution will be subject to withholding tax if the fund was domiciled in Switzerland).

h) Structured products

The interest component of domestically issued structured products (e.g. reverse convertibles) is currently subject to withholding tax. With the proposed abolition of withholding tax on bond interest, withholding tax on the interest component of structured products will also cease to apply. This will facilitate the issuance of structured products with an interest component (e.g. reverse convertibles) from within Switzerland. However, fund-like structured products are still subject to withholding tax, which is why such products may continue to be issued from abroad.

i) Transfer stamp duty on foreign bonds

Bonds issued abroad continue to be subject to the 0.3% transfer stamp duty if a domestic securities dealer is involved in the transaction as a party or intermediary. The distinction between "bonds" (subject to transfer stamp duty) and "single loans" (not subject to transfer stamp duty) will be made, as today, by applying the so-called 10/20 non-bank rules (see Section III.C above).

A bond issued abroad retains the qualification as a "foreign bond" even if such bond will be "on-shored" by way of a change of issuer. Conversely, a bond issued in Switzerland becomes a foreign bond after a change of debtor to a foreign country.

4) Tax at source on claims of a foreign creditor secured by domestic real estate

No legislative change is proposed with respect to the tax at source on bonds and loans of foreign resident creditors secured by domestic real estate. The interest of such bonds or loans is still subject to a withholding tax of 13% to 33% in the canton where the respective property is located (see in detail Stefan Oesterhelt and Maurus Winzap, Quellensteuern auf hypothekarisch gesicherten Kreditverträgen, FStR 2008, 28 ff.).

Since the tax at source on mortgage-backed claims may only be levied outside the scope of the withholding tax, the scope of the tax at source will naturally become larger with the abolition of withholding tax on interest payments. This is particularly problematic if the abolition of withholding tax were to affect not only bonds issued after the entry into force of the withholding tax reform, but (as currently envisaged; see Section III.V below) all interest payments. This would, for example, affect covered bonds issued by a resident and secured by domestic mortgages which are subject to withholding tax.

5) Entry into force expected on 1 January 2024

The reform could be debated by Swiss Federal Parliament at the end of 2021 at the earliest. It is expected that the abolition of withholding tax will enter into force the earliest on 1 January 2024 (if accepted by the Swiss Federal Parliament).

The transitional provision provides that withholding tax will no longer be levied on interest from the effective date of the new law (i.e. likely as of 1 January 2024). This means that the new provisions will also apply to bonds issued before that date. In order to reduce the fiscal cost arising of the abolition of withholding tax on bond interest, it might be a compromise to limit the scope to bonds issued after that date. This could reduce the costs without having a negative impact on the overall economy. In addition, this could solve the problem of the resurgence of tax at source on mortgage-backed claims of bonds currently subject to withholding tax (e.g. covered bonds).

6) Conclusion

The abolition of withholding tax on bond interest will enable domestic groups to issue bonds domestically in future. This strengthens Switzerland's position in the international capital market. In addition, it will become more attractive to locate group financing activities of international group of companies in Switzerland. The abolition of withholding tax on bond interest is associated with fiscal costs and is therefore subject to political headwind. However, if the reform achieves to spur capital market and group financing activities, it will likely outweigh the costs in the long term. In addition, the tax costs and associated concerns could also be somewhat mitigated by redrafting the transitional provision and applying it only to bonds issued after entry into force of the proposed withholding tax reform.

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The use and modalities of opting out/up clauses – new developments

Reference: CapLaw-2021-36

In the case of MCH Group AG, the Swiss Takeover Board and FINMA refined their practice regarding the consent of the majority of the minority shareholders to the introduction of an opting out/up by clarifying who is considered to be a minority shareholder and which quorum is used to determine the voting result.

By Dr. Dieter Dubs / Fabienne Perlini-Frehner

1) Legal basis

a) The obligation to make an offer and its exclusion

According to art. 135(1) FMIA, a person who acquires equity securities directly, indirectly or acting in concert with third parties and thereby, together with the equity securities he/she already owns, exceeds the threshold of 33 1/3% of the voting rights of a target company, whether exercisable or not, is obliged to make an offer for all listed equity securities of the target company.

The central regulatory content of art. 135 FMIA is the protection of the minority shareholders (see dispatch (*Botschaft*) of 24 February 1993 on a Federal Act on Stock Exchanges and Securities Trading ("**DISPATCH SESTA**"), Federal Gazette ("**FG**") 1993 I 1369 et seqq., 1389). According to the legislator's conception, the protection of minority shareholders should be realised by means of an obligation to make an offer once a shareholder reaches the threshold of 33 1/3% of the voting rights (DISPATCH SESTA FG 1993, 1417; Takeover Board ("**TOB**") Order 594/01 of 5 March 2015 in the matter of Sika AG; rec. 1.2.1). The obligation to make an offer, "*gives minority shareholders the opportunity to protect themselves against the control of their company by a new group of shareholders, which could bring about significant changes in corporate policy*" (*original text in German*) (DISPATCH SESTA FG 1993, 1417). Minority shareholders should thus be given the opportunity to exit their investment (exit right) in the event of a change in control, i.e. in the event that a (new) majority shareholder or a group of shareholders takes control of the company (DISPATCH SESTA FG 1993, 1417).

The FMIA allows companies to exclude the obligation to make an offer by including a respective provision in their articles of association. From a material point of view, the FMIA distinguished between an initial (art. 125(3) FMIA) and a subsequent (art. 125(4) FMIA) opting up/opting out.

The exclusion of the obligation to make an offer requires that an opting out clause be included in the articles of association. The inclusion of an opting out clause prior to the

equity securities of a company being admitted to official listing on a stock exchange is governed by art. 125(3) FMIA. After the listing, a company may at any time include an opting out clause "*in its articles of incorporation, provided that this does not prejudice the interests of shareholders within the meaning of Article 706 CO*" (art. 125(4) FMIA).

The FMIA also allows companies to raise the threshold relevant for an offer obligation from 33 1/3% to 49% of the voting rights in their articles of association. In this case, one speaks of an opting up clause pursuant to art. 135(1), last sentence, of the FMIA. Art. 125(3) and (4) FMIA apply by analogy to opting up cases.

An opting out or opting up clause, respectively, is effective at the time it is entered in the commercial register as an amendment to the articles of association. Consequently, the entry in the commercial register must be made before the threshold is exceeded.

In the context of the history of the SESTA, the obligation to make an offer was a controversial legal institution (cf. in particular the information on the parliamentary deliberations in TOB Order 610/01 of 21 July 2015 in the matter of Schindler Holding AG, N 11). It was argued against the obligation to make an offer that such an obligation would impermissibly reduce the value of majority shareholdings by obliging controlling major shareholders to share a possible control premium with the other shareholders. It was also said that as a result of the obligation to make an offer, public takeover offers would not be made, which would also violate the interests of minority shareholders (see also the decision of the Takeover Committee of the Swiss Financial Market Supervisory Authority FINMA of 4 May 2015 in the matter of Sika AG, N 37). In the legislative process, the opting out was the compromise without which the general obligation to make an offer pursuant to art. 32 SESTA would not have existed (see also Rudolf Tschäni/Hans-Jakob Diem/Tino Gaberthüel, Öffentliche Kaufangebote, 4th edition, Zurich 2020, N 75).

b) Opting out/up before listing (art. 125(3) FMIA)

Pursuant to art. 125(3) FMIA, companies may, prior to their equity securities being admitted to official listing on a stock exchange, stipulate through the inclusion of a corresponding clause in their articles of association that an acquirer is not obliged to make a public takeover offer if he/she/it reaches or exceeds the threshold of 33 1/3% of the voting rights or a higher threshold according to the articles of association. An opting out/up introduced prior to their listing of the equity securities will not be examined by the TOB for its validity – with reservation of grounds for nullity. In this case, the resolution introducing the opting out/up and amending the articles of association can only be challenged in accordance with the rules of company law (art. 706 and art. 706a CO).

The spin-off of a (target) company from a listed company constitutes a special case. In this case, the opting out/up clause in the articles of association of the spun-off (target) company is only unconditionally valid if the listed company already had a legally effective opting out/up clause in its articles of association (TOB Order 556/02 of 2 February 2014 in the matter of Walter Meier AG/WM Technologie AG, rec. 5).

Presumably, the same applies in case of a merger: if a transferring listed company without an opting out/up clause is merged into a receiving listed company with an opting out/up, it can be assumed that the receiving company must confirm the already formally existing opting out/up by passing a new resolution at the shareholders' meeting which resolves on the merger and that this resolution must fulfil the requirements for effectiveness of a subsequently introduced opting out/up.

c) Opting out/up after listing (art. 125(4) FMIA)

Art. 125(4) FMIA stipulates that a company may at any time – i.e. after the listing of its equity securities – include an opting out clause in its articles of association. According to the wording of the law, the prerequisite for a subsequent opting out is that this "*does not prejudice the interests of shareholders within the meaning of Article 706 CO*". According to the practice of the Swiss Takeover Board ("**TOB**"), the same requirement also applies to a subsequently introduced opting up clause (TOB Order 590/01 of 20 February 2015 in the matter of Leclanché S.A., rec. 1).

2) Modalities and use cases of opting outs/ups

a) Types of opting out/up

A general opting out generally excludes the obligation to make an offer (and thus the application of the minimum price rules according to takeover law). The effect of a general opting up, by which the threshold triggering the obligation to make an offer is increased, is analogous.

In contrast, an opting out/up can also be formally or materially (transaction-related) selective, so that only a certain shareholder or group of shareholders is exempted from the obligation to make an offer. Formally selective means that the "favoured" shareholders are explicitly named in the statutory exemption clause.

After in practice, for a long time a *numerus clausus* of statutory forms of exemption from the obligation to make an offer applied – i.e. only a general opting out or up was declared permissible (on the inadmissibility of a formally selective opting out (at that time still referred to as "partial" opting out) see the decision of the Takeover Chamber of the Swiss Federal Banking Commission of 23 June 2000 in the matter of Esec Holding AG) – in 2015, with TOB Order 600/01 of 22 April 2015 in the matter of

Kaba Holding AG, there was a change in practice. Since the issuance of this order, formally selective opting out clauses are (again) permissible.

b) Use cases of opting out/up

An opting out/up – in practice now regularly a selective opting out/up – comes into consideration in particular for the following transactions:

- In the context of the acquisition of a company, the (target) company settles the purchase price with shares. This exchange of shares results in the owner respectively shareholder of the shares of the (target) company acquired in this way exceeding the threshold triggering the obligation to make an offer.
- In the context of a capital increase, a new or existing shareholder exceeds the threshold triggering the obligation to make an offer because, for example, such shareholder materially acts as underwriter respectively acquires all shares not acquired by shareholders via exercise of subscription rights.
- In the context of a reorganisation, either an equity-adding shareholder and/ or banks exceed the threshold triggering the obligation to make an offer as a result of a dept equity swap.
- A shareholder makes a partial offer and exceeds the threshold triggering the obligation to make an offer, but does not want to launch a full offer (whether the TOB would accept such a condition in an offer is untested).

c) Examples of statutory opting outs/ups

The practice of the TOB allows companies and shareholders a wide scope in the formulation of an opting out/up, so that tailor-made exemptions from the obligation to make an offer are possible, as the following two examples show:

Example dormakaba Holding AG

The extraordinary shareholders' meeting of Kaba Holding AG of 22 May 2015 approved the inclusion of the following formally selective opting out into the articles of association. After adjustments due to changes in the law, the corresponding clause in the articles of association reads as follows:

1. Articles of Incorporation dated 20 October 2020

§ 5a – Opting Out

In the following cases, Familie Mankel Industriebeteiligungs GmbH + Co. KGaA and Mankel Family Office GmbH as well as their respective direct or indirect quota holders

– individually or together with shareholders of the Company with whom they entered into a pool agreement (Shareholder Pool) in connection with the combination of KABA Group with DORMA Group – are exempted from the obligation to make an offer pursuant to Article 135 para. 1 of the Swiss Federal Act on Financial Market Infrastructures and Market Conduct in Securities and Derivatives Trading of June 19, 2015:

(a) Combination of KABA Group with DORMA Group pursuant to the transaction agreement dated April 29, 2015 between Familie Mankel Industriebeteiligungs GmbH + Co. KGaA and Mankel Family Office GmbH on the one hand and the Company on the other hand;

(b) Transactions in shares of the Company between parties of the Shareholder Pool and/or with third parties that result in changes of the majorities within the Shareholder Pool, changes in the composition of the Shareholder Pool or changes in the direct overall participation of the parties to the Shareholder Pool in the Company, as long as such a direct overall participation does not exceed 33 1/3% of the voting rights in the Company;

(c) Dissolution of the Shareholder Pool;

(d) Consummation of the transfer agreement described in § 36 of the Articles of Incorporation.

Example MCH Group AG

The extraordinary shareholders' meeting of MCH Group AG of 3 August 2020 decided to include the following formally selective opting up in the articles of association (text from articles of association; German text is identical to the text from the minutes of extraordinary shareholders' meeting of 3 August 2020):

2. Articles of Association dated 21 December 2020

§ 5a

In the event and to the extent that Lupa Systems LLC, New York, USA (Lupa) and/or its beneficial owner – alone or together with persons controlling Lupa, under common control like Lupa or acting in concert with Lupa – (i) through subscription or acquisition of registered shares of the Company in the context of the capital increase to be carried out in 2020, and/or (ii) through acquisitions or acting in concert after the capital increase carried out in 2020, exceeds the threshold of 33 1/3% but not the threshold of 49% of the voting rights of the Company, Lupa as well as persons controlling Lupa, are under common control like Lupa or act in concert with Lupa are exempt from the obligation to make a public takeover offer pursuant to article 135 of the Federal Act on Fi-

nancial Market Infrastructures and Market Conduct in Securities and Derivatives Trading of June 19, 2015 (FinfraG).

These examples prove that according to the practice of the authorities, it is also permissible to make future facts subject to an exemption in a corresponding statutory provision.

d) Limits: No statutory modifications of the obligation to make an offer through corresponding opting-out/up provisions

The obligation to make an offer and the possible exemptions from the obligation to make an offer by way of opting out or up clauses are to be regarded as a conclusive, self-contained system of takeover law. According to previous practice, selective opting out/up clauses are permissible within a limited scope of application. However, (target) companies cannot formulate individual takeover rules in their articles of association which go beyond this practice. Statutory offer obligations that deviate from the system prescribed by the law and the ordinances are not possible. Corresponding provisions in the articles of association are null and void. The following statutory provision proposed by Schindler Holding AG serves as an example: an acquirer of 50% or more of the share capital is only entered in the share register as a shareholder with voting rights if he/she has previously launched a public takeover offer with an offer price which must be at least equal to the market price and at most 10% below the maximum price paid in previous months. The TOB has declared such modifications of the legal obligation to make an offer null and void (Order 610/01 of 21 July 2015 in the matter of Schindler Holding AG, rec. 3 et seq.).

3) Examination of the validity of a subsequent opting out/up

The legal basis for the subsequent statutory exemption from the obligation to make an offer through an opting out/up provision is art. 125(4) FMIA. Such a waiver of the obligation to make an offer is permissible "*provided that this does not prejudice the interests of shareholders within the meaning of Article 706 CO*". According to this wording of the law, the purpose of the opting out/up is to ensure that individual shareholders are not deprived of their rights in an unjustified manner or treated unequally; in terms of company law, this concerns the application of art. 706(2)(2) and (3) CO.

a) Examination under stock corporation law

The resolution on the introduction of an opting out/up can be challenged by the shareholders by civil action in accordance with the contestation rules under company law. If the resolution to introduce the opting out/up is not challenged, the opting out/up is valid under company law. The same applies if any legal challenge is rejected by the court.

b) Examination of effectiveness under takeover law by the Swiss Takeover Board

The practice of the TOB considers the legal reference to art. 706 CO in art. 125(4) FMIA to be an additional requirement for validity under takeover law. Thus, the TOB also considers this reference as the basis for its competence to review the validity of a subsequent opting out/up under takeover law. In its Order 594/01 of 5 March 2015 in the matter of Sika AG, the TOB in N 13 states the following regarding this reference to company law: "*This reference to art. 706 CO is considered to be an additional (stock exchange law) validity requirement, and thus the basis for the Swiss Takeover Board's competence to review the validity of a subsequent opting out.*" (*original text in German*)

In accordance with current practice (see in particular Order 594/01 of 5 March 2015 in the matter of Sika AG, rec. 1.2; Order 518/01 of 11 October 2012 in the matter of Advanced Digital Broadcast Holdings SA; Order 539/01 of 24 June 2013 in the matter of Logan Capital AG, rec. 3), the TOB examines the effectiveness of a subsequently introduced opting out/up under takeover law as follows: A subsequent opting out/up is effective under takeover law (since Order 686/01 of 20 March 2018 in the matter of Addex Therapeutics SA, N 2 et seq., this is the established practice) if

1. the shareholders are informed transparently about the introduction of the opting out/up and its consequences;

2. the majority of the votes represented at the shareholders' meeting and the majority of the minority shareholders agree to the opting out/up; and

3. the interests of the minority shareholders are not prejudiced within the meaning of art. 125(4) FMIA and art. 706 CO, whereby this is presumed if the two aforementioned conditions are met; only in case of special and exceptional circumstances, the TOB substantively examines art. 706 CO and may – in deviation from the voting result of the majority of the minority shareholders – determine that the interests of the minority shareholders are prejudiced and that the opting out/up is invalid.

If the first and second of these conditions are met, according to the practice there is a factual presumption that the opting out/up does not prejudice the interests of the minority shareholders within the meaning of art. 125 para. 4 FMIA in conjunction with art. 706 CO, "*although this presumption may be overturned in the event of special and exceptional circumstances*" (*original text in German*) (Order 686/01 of 20 March 2018 in the matter of Addex Therapeutics SA, N 2 et seq.).

It is unclear whether the third requirement also applies in the case of a general opting out/up; this is because an unequal treatment of shareholders can only exist as a result of the selectivity of the exemption from the obligation to make an offer. It is therefore conceivable that only in the case of formally selective opting outs/ups, there

is this additional effectiveness requirement of the test that the unequal treatment of shareholders is justified by the relevant corporate interest.

4) The takeover law requirements for effectiveness in detail

a) Transparency requirement

From a formal point of view, the transparency requirement requests that the information required to meet this requirement be disclosed both in the invitation to the shareholders' meeting and at the shareholders' meeting itself immediately prior to the relevant resolution being taken. The purpose of the transparency requirement is to inform the shareholders so that each shareholder can cast an undistorted, free and conscious vote regarding the introduction of the opting-out/up. From a material point of view, the information fulfils the transparency requirement if the actual intentions of the applicant requesting or benefiting from the introduction of the opting out/up and his/her intentions as a controlling shareholder are disclosed. In addition, the general consequences of the introduction of the opting out/up as well as the concrete effects must be described. In particular, the transparency requirement also requires that shareholders are informed about specifically planned projects and negotiated transactions with investors (see TOB Order 590/01 of 20 February 2015 in the matter of Leclanché S.A., rec. 1.1 and TOB Order 539/01 of 24 June 2013 in the matter of Logan Capital AG, rec. 1.1).

The TOB regularly describes this transparency requirement as follows (quote from Order 539/01 of 24 June 2013 in the matter of Logan Capital AG, rec. 7; see also Order 518/01 of 11 October 2012 in the matter of Advanced Digital Broadcast Holdings SA, rec. 5; Order 600/01 of 22 April 2015 in the matter of Kaba Holding AG, N 4): "*An opting up materially satisfies the requirement of transparency if the actual intentions of the applicant requesting the introduction of the opting up as well as the intentions of the controlling shareholder are specified. In addition, the general consequences of the introduction of the opting up as well as the concrete effects at the company under discussion must be specified. The applicant shall provide information on the reasons for his/her proposal, the intended transaction and the resulting change of control. The board of directors shall explain the general and concrete consequences of the opting up for the company and clarify that an opting up – unless it is formally selective – can be invoked by all current and future shareholders in the event of a change of control. This information and consequences in case of an introduction of an opting up shall already be communicated to the shareholders with the invitation to the shareholders' meeting.*" (*original text in German*)

b) Consent of the majority of minority shareholders

If the transparency requirement is fulfilled, the TOB examines whether the "*interests of the minority shareholders are prejudiced*" insofar in a procedural manner as a "special meeting" of the minority shareholders is required and their consent to the introduction of the opting out/up establishes the presumption of correctness. An opting out/up is only valid under takeover law if (a) the majority of the votes represented at the shareholders' meeting or the ordinary quorum applicable at the company for amendments to the articles of association and (b) the majority of the minority shareholders at the shareholders' meeting approve the proposal.

If the majority of minority shareholders votes against the introduction of an opting out/up, it is presumed that the interests of the minority shareholders are prejudiced, even if the majority of the votes represented at the shareholders' meeting approves the proposal. According to the practice of the TOB, in order to determine the voting result of the minority shareholders, it is sufficient to count the votes cast separately and to determine the result of the resolution separately in this respect (special assessment); consequently, an actual special vote is not necessary.

For this special assessment of the "majority of the minority shareholders", it is necessary to establish who is considered to be a minority shareholder and which quorum is used to determine the voting result. The TOB and FINMA have clarified these legal issues in the case of MCH Group AG and refined their practice.

i. Voting entitlement in the special assessment under takeover law

With regard to this "special vote" of the minority shareholders, it is necessary that the voting entitlement of the shareholders is defined. In the recent practice of the TOB, the delimitation of those entitled to vote in the "special vote" is regularly made as follows: A minority shareholder who is entitled to vote is "*a person who neither directly nor indirectly or acting in concert holds a share of 33 1/3% of the voting rights in the target company nor has applied to the board of directors for the introduction of opting out*" (*original text in German*) (Order 601/01 of 22 April 2015 in the matter of Kaba Holding AG, N 7; see also Order 686/01 of 20 April 2018 in the matter of Addex Therapeutics SA, N 8).

In the case of MCH Group AG, both the TOB and FINMA stated that the votes of a shareholder with a participation of more than 33 1/3% may not be counted in the special meeting, even if this controlling shareholder is not favoured by a selective opting out/up. This is because the counting of such votes "*would have the consequence that with his voting power, the controlling shareholder could (also) dominate the vote of the majority of the minority and thus, where applicable, decide over the heads of the minority shareholders on the introduction of such a selective opting out/up and the associated allocation of the preferential treatment to a third party. This would, however,*

not be compatible with the protective concept of the requirement of the majority of the minority" (*original text in German*) (Order 765/02 of 20 August 2020 in the matter of MCH Group AG, N 41). This understanding was supported by FINMA, but mainly on the grounds that without the consent of the controlling shareholder, the transaction or capital increase as agreed (and the selective opting up was an element of the transaction) would not have occurred, and by not taking into account the votes of the controlling shareholders, "*there is ultimately an appropriate balance of power in terms of the protection of the minority shareholders: The minority shareholders are given a collective veto on the veto right of the controlling shareholder, which ensures that the decision is supported not only by the controlling shareholder, but also by the minority shareholders*" (Order of the Takeover and State Liability Committee of the Swiss Financial Market Supervisory Authority FINMA in the matter of MCH Group AG, N 49).

The decision criteria for the voting entitlement are thus, as a result, formal aspects of the introduction of an opting out/up: the applicant, who will regularly also be the beneficiary of the exemption from the obligation to make an offer brought about by the opting out/up, the other beneficiaries as well as the "controlling" shareholders are not entitled to vote.

ii. Quorum for determining the result of the special assessment

In the case of MCH Group AG, it was disputed on what basis the result of the special vote of the minority shareholders was to be determined, i.e. whether the quorum rule according to the articles of association – absolute majority of the votes cast – was to be applied or whether the result was to be determined independently of the rules laid down in the articles of association. The TOB determined that "*for establishing the approval of the majority of the minority […] the majority of the votes of the minority shareholders represented at the shareholders' meeting is to be used*" and that "*with regard to the evaluation of the votes in the special count, the ordinary simple majority quorum relevant according to company law does not apply*" (*original text in German*) (Order 765/02 of 20 August 2020 in the matter of MCH Group AG, N 52). The FINMA supports this view and stated, *inter alia*: "*The TOB is materially competent to determine the requirements for the validity of a subsequent opting up under takeover law pursuant to art. 125(4) FMIA (art. 126(3) FMIA). Accordingly, the TOB is authorised not only to provide for the additional takeover law requirements of transparency and the consent of the "majority of the minority", but also to determine the voting modalities with regard to the latter, as it has done by referring to the votes represented. It follows from this that it does not have to follow either the dispositive character of art. 703 CO or the statutory provisions of the MCH Group.*" (*original text in German*) (Order of the Takeover and State Liability Committee of the Swiss Financial Market Supervisory Authority FINMA in the matter of MCH Group AG, N 59).

c) No disadvantage for minority shareholders

If the shareholders are informed transparently about the introduction of the opting out/up and the "majority of the minority" decides in favour of the introduction of the opting out/up, the TOB examines whether the introduction of the opting out/up results in the interests of the minority shareholders being prejudiced. This practice is intended to prevent circumventions of the protection of minorities under stock exchange law (exit right in the event of a change of control).

The presumption of correctness, which is established in case of an "approval of the majority of the minority" – i.e. in the second resolution of the "double resolution" or counting of votes, respectively – can be overturned if special and exceptional circumstances exist. The TOB thus reserves the right to conduct a substantive examination of art. 706 CO despite the actual presumption of the correctness of the decision of the shareholders' meeting. However, according to the practice of the TOB, the actual presumption of correctness is generally accepted in the case of such approval; because according to this practice, "*the decision of the shareholders at the shareholders' meeting shall not be interfered with without good cause*" (*original text in German*) (Order 539/01 of 24 June 2013 in the matter of Logan Capital AG, N 15).

An opting out/up may be permissible if the interests of the shareholders are not prejudiced in the sense of art. 706 CO. According to art. 706(2)(2) and (3) CO, a resolution of a shareholders' meeting may not remove rights of shareholders in an improper manner or give rise to the unequal treatment or disadvantaging of shareholders in a manner that is not justified by the company's purpose. "*A removal in an improper manner exists, for example, if the majority exercises its voting power against the company's purpose in order to pursuit non-corporate goals. This is the case when shareholders' rights have been restricted or removed not to promote the company's interests, but to pursue the majority's personal goals. An unjustified unequal treatment or disadvantage exists if these is not justified by the company's interests*" (*original text in German*) (Order 440/01 of 4 June 2010 in the matter of COS Computer Systems AG, rec. 2.1; Order 437/01 of 4 March 2010 in the matter of CI Com SA, rec. 2.1, with further references).

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VectiveBio Holding AG's IPO on Nasdaq

Reference: CapLaw-2021-37

On 9 April 2021, VectivBio Holding AG announced its initial public offering and listing of its shares on Nasdaq (ticker symbol VECT). VectivBio is a clinical stage biopharmaceutical company focused on the discovery, development and commercialization of innovative treatments for severe rare conditions for which there is a significant unmet medical need. Through its IPO, at USD 17 per share, VectivBio raises gross proceeds of USD 146.6 m (including greenshoe). At market close on the first day of trading, VectivBio had a market capitalization of USD 824m.

Credit Suisse Group AG's Issuance of Mandatory Convertible Notes

Reference: CapLaw-2021-38

On 22 April 2021 Credit Suisse Group AG announced the placement of two series of Mandatory Convertible Notes (CHF 865,000,000 3.00 per cent. Series A Mandatory Convertible Notes due 2021 (Series A) and CHF 890,949,000 3.00 per cent. Series B Mandatory Convertible Notes due 2021 (Series B)), issued through a Guernsey finance vehicle and convertible into a total of 203 million shares of, and guaranteed by, Credit Suisse Group AG. The MCNs were priced on 23 April after close of trading and issued on 12 May.

PolyPeptide Group AG's IPO on SIX Swiss Exchange

Reference: CapLaw-2021-39

On 29 April 2021, PolyPeptide Group commenced trading on SIX Swiss Exchange. The offering consisted of 3,125,000 new shares as well as 8,396,740 existing shares offered by PolyPeptide's sole shareholder, Draupnir Holding B.V., at an offer price of CHF 64.00 per share (with an over-allotment option of up to 1,728,261 existing shares), which implies a total placement volume of up to CHF 848m. Trading opened at CHF 72.50 and closed on the first trading day at CHF 78.20, which represents a rise of more than 22 per cent from the offer price and implies a total market capitalization of CHF 2.59bn.

PolyPeptide is a Contract Development & Manufacturing Organization (CDMO) focusing on proprietary and generic GMP-grade peptides used by pharmaceutical and biotech

companies in approved pharmaceutical products, drugs in clinical development as well as in generic products. Dating back to 1952, PolyPeptide today manufactures around one-half of all currently approved peptide drug substances with a global footprint of six GMP-certified facilities in Europe, the U.S. and India. As a multinational company with more than 900 employees, its diversity brings breadth, depth of knowledge and experience to the group. PolyPeptide has grown organically and by selective acquisition of existing expertise, culminating in its position today as a leader in outsourced peptide manufacturing.

Santhera Pharmaceuticals Holding AG's Exchange Offer for a Convertible Bond

Reference: CapLaw-2021-40

On 4 May 2021, Santhera Pharmaceuticals Holding AG (SIX: SANN) announced the settlement of the first exchange offer for a convertible bond in Switzerland. Holders of Santhera's existing CHF 60 m Senior Unsecured Convertible Bonds due 2022 received one new CHF 30,270,375 Senior Unsecured Convertible Bond due 2024 and 26 Santhera shares per existing bond. The offer had been accepted by holders of 74.7% of the former bonds.

Credit Suisse Group AG's Issuance of USD 3.25bn Bail-inable Notes

Reference: CapLaw-2021-41

On 10 May 2021, Credit Suisse Group AG launched, and on 14 May 2021, successfully completed, the issuance of USD 3.25bn 3.091% Fixed Rate/Floating Rate Senior Callable Notes due 2032 under its U.S. Senior Debt Program. The Notes are bail-inable bonds that are eligible to count towards Credit Suisse's Swiss gone concern requirement. The offering of the Notes was done in reliance on Rule 144A and Regulation S under the U.S. Securities Act. The Notes have been provisionally admitted to trading, and application has been made for admission and listing of the Notes, on the SIX Swiss Exchange.

Jacobs Holding AG's Placement of 550,000 Shares in Barry Callebaut

Reference: CapLaw-2021-42

On 10 May 2021, Jacobs Holding AG successfully placed 550,000 shares (approx. 10%) in Barry Callebaut AG by way of an accelerated bookbuilding process. With a stake of 30.1%, Jacobs Holding remains the reference shareholder in Barry Callebaut.

Montana Aerospace AG's IPO on SIX Swiss Exchange

Reference: CapLaw-2021-43

On 12 May 2021, Montana Aerospace AG commenced trading on SIX Swiss Exchange. The offering consisted of 17,153,997 new shares at an offer price of CHF 25.65 per share (with an over-allotment option of up to 2,573,099 existing shares offered by Montana Tech Components AG), implying an offering volume of approximately CHF 506m and a total market capitalisation of approximately CHF 1.2bn.

Montana Aerospace is a leading, highly-vertically integrated manufacturer and supplier of system components and complex assemblies for the aerospace, e-mobility and energy sectors with worldwide engineering and manufacturing operations.

Trifork Holding AG's IPO on Nasdaq Copenhagen

Reference: CapLaw-2021-44

On 1 June 2021, Trifork Holding AG commenced trading on Nasdaq Copenhagen. Trifork's IPO was priced at DKK 150 and consisted of the sale of 6,165,647 existing shares sold on behalf of the selling shareholders and 940,233 new shares sold by Trifork. The total value of the Offering (not including the over-allotment option, if exercised) amounts to approximately DKK 1.066bn. The Offering corresponds to a total market value of all issued shares of the Company of approximately DKK 2.962bn.

Trifork Group, headquartered in Schindellegi, Switzerland, with offices in 11 countries in Europe and North America, is an international IT group focusing on the development of innovative software solutions. The group was founded in Denmark in 1996 and now has more than 800 employees in business units, focusing on three vertical business areas: Digital Health, FinTech and Smart Buildings and three horizontals: Cloud Operations, Cyber Protection and Smart Enterprise.

Quo Vadis – Finanzplatz Schweiz?

Tuesday, 31 August 2021, University of Zurich, Rämistrasse 59, Zurich

https://www.eiz.uzh.ch/EIZ/web/eiz/web.aspx?PageID=48&WPParams=43A9B2A7C6D4E0E8AAB08D92A897A5

Capital Markets – Law and Transactions XVII *(Kapitalmarkt – Recht und Transaktionen XVII)*

Wednesday, 17 November 2021, Metropol, Zurich

https://www.eiz.uzah.ch/EIZ/web/eiz/web.aspx?PageID=48&WPParams=43A9B2A7C6D4E0E8AAB08D92A8999E

St. Gall Conference on Financial Markets Regulation *(St.Galler Tagung zur Finanzmarktregulierung)*

Tuesday, 18 November 2021, Hotel Widder, Zurich

https://lam.unisg.ch/tagung/finanzmarktregulierung

In light of the new data protection laws, CapLaw has released a privacy statement. The privacy statement, as updated from time to time, is available on our website (see http://www.caplaw.ch/privacy-statement/). For any questions you may have in connection with our data processing, please feel free to contact us at privacy@caplaw.ch.