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Cross-Border Transactions in Intermediated Securities: Switzerland Maintains its Lead (Part 1/2)

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On 1 April 2017, the Hague Convention on the Law Applicable to Certain Rights in Respect of Securities held with an Intermediary entered into force. The entry into force of the Convention coincides with renewed efforts by the European Commission at modernising the conflicts rules for the third-party effects of transactions in book-entry securities and financial claims in the overall context of the Capital Markets Union action plan.

By Thomas Werlen / Matthias Wühler

"The business is so constant and incessant that hardly a definite place can be named where it goes on."

Joseph de la Vega, Confusion de confusiones [1688]: Portions descriptive of the Amsterdam Stock Exchange (Baker Library, 1957), as quoted in *Corzo et al.*, 15 THE JOURNAL OF BEHAVORIAL FINANCE 341, 343 (2014)

On 1 April 2017, the *Hague Convention on the Law Applicable to Certain Rights in Respect of Securities held with an Intermediary* (Hague Securities Convention, the **Convention**) entered into force. The entry into force of the Convention coincides with renewed efforts by the European Commission (COM(2015) 468 final, p. 23 et seq.) at modernising the conflicts rules for the third-party effects of transactions in book-entry securities and financial claims in the overall context of the Capital Markets Union action plan (on the CMU, see *Sester*, CapLaw-2015-56).

Nearly eight years have passed since the promulgation of the Swiss Federal Act on Intermediated Securities (FISA). This year's entry into force of the Hague Convention again puts a spotlight on the Swiss legislation in the domain of intermediated / book-entry securities. Without a doubt, this will serve to strengthen Switzerland's reputation as a global benchmark for high-quality legislation. We wish to take this opportunity to place the Swiss legal framework for intermediated securities in the broader international context.

In this, the first of our two-part contribution, we have taken a high-level view. We set out, after a brief introduction (1.), the basic structure of the prevailing intransparent securities holding systems (2.). We then provide an overview of the various ways in which the American legal system reflects these market realities (3.).

In the second part of our contribution, we will briefly review FISA, the Swiss equivalent to Article 8 of the Uniform Commercial Code, before focusing on conflicts issues in the cross-border trade in intermediated securities. In particular, we will discuss the Hague Securities Convention and the ongoing attempts by the EU to arrive at, if not harmonised substantive laws, a coherent private international law framework for intermediated securities.

1) Introduction

The days of individual investors holding physical security certificates are long gone, but one still encounters vestiges of the past in the terminology of financial markets. Market participants may speak of *physical delivery* or *physical settlement* of transactions referencing book-entry securities. Investors may be overheard discussing the *coupon* or *coupon rate* of a fixed-income security, even though bonds no longer materialise as certificated bearer securities with coupons.

Much as the chirographs on early bearer securities, the doctrine and language of a particular jurisdiction may hark back to ancient practices. In the case of intermediated securities, some jurisdictions continue to conceive of the interest an investor holds in an intermediated security in the traditional categories of property law or the law of obligations. Other jurisdictions have introduced new, openly hybrid, legal institutions specifically for the trade in intermediated securities (for an overview of the Swiss legislation, we refer to *Reutter*, CapLaw-2010-2; *Sulzer*, CapLaw-2010-1 and *Costantini*, CapLaw-2009-55).

Nowadays, where an investor acquires a unit of a share or part of a bond issuance, that investor enters a (frequently international) web of legal relationships mainly characterised by contract. Various jurisdictions differ in the extent to which they reflect this contractual foundation of modern securities intermediation. The different doctrinal perspectives may in part explain the difficulty in arriving at uniform international solutions.

As words have taken on new meanings and novel infrastructures have opened up new linguistic dimensions (Trans-European Automated Real-time Gross Settlement Express Transfer System), the fast-paced securities markets have brought about new legal concepts and continue to test the flexibility of traditional rules. This makes the cross-border trade in intermediated securities and their cross-border custody a fascinating area of law.

2) Modern Systems of Securities Intermediation

The current, indirect and intransparent systems of securities intermediation prevailing in the United States, Switzerland and most of the EU (we do not address transparent systems) are based on *contractual* relationships. The terms and conditions of these contracts are of enormous importance to the position of investors seeking exposure to financial assets traded as intermediated securities, in particular in a cross-border context.

a) Book Entries in Securities Accounts as the Basis of Modern Systems

In these indirect systems, asking whether or not an investor owns securities may be misleading. The investor is first and foremost an accountholder at a custodian that acts as that investor's contractual counterparty. This is crucial. The custodian is not merely incidental to the investor's securities holdings, somehow facilitating them and serving as a repository for ancillary services. The custodian is the investor's only direct point of contact with the system, the gatekeeper to the securities infrastructure. For most investors, it is impossible to hold securities in the absence of a custody agreement. The agreements between the investors and their custodians constitute the bottom of the securities holding pyramid. From the perspective of the investor, the account with the custodian is the decisive element.

This is not a new insight. On 2 March 1976, the Swiss Federal Supreme Court explained, in the context of an enforcement proceeding between two Julius Bär clients (BGE 102 III 94 pp. 105 et seq., authors' translation):

> *The client generally does not know which correspondent bank holds the securities in custody. In the present case, it appears not even the petitioner would know the country of custody for all the securities. The custodian bank in turn does not know the name of the client, it only knows the name of the Swiss bank for which it holds a number of securities. We must also take into account that in certain countries, certain kinds of securities are increasingly on deposit with central securities depositories. Only banks and brokers may transact with these central depositories. We deem it extremely unlikely that the foreign laws governing these relationships would allow for direct attachment at the level of the central securities depository. (...) The prevailing view is that a portfolio of shares is located with the bank providing the securities account, wherever the physical securities certificates may be located. Generally speaking, the client can only access his securities via the custodian bank. (...) A client who owns securities on deposit at a Swiss bank will deem his patrimony to be located in Switzerland. He does not normally know where these securities are actually located. As long as the client can freely instruct the bank providing the securities account to dispose of the securities, he may be indifferent to this question.*

b) Immobilisation of Securities at Central Securities Depositories

At the top of the securities holding pyramid is the *central securities depository* (CSD). Each jurisdiction has at least one CSD. The CSD provides collective custody of securities, custody of a global securities certificate (a physical certificate representing an entire issuance) or a non-certificated security (i.e. a book-entry security that is fully dematerialised). By keeping the securities in custody at the CSD, securities are *immobilised*. This enables their transfer by way of book entry.

c) Sub-custodians

If all investors held an account at the CSD, transactions between them could be settled by crediting and debiting their accounts at the CSD. In reality, the system is much more intermediated. The CSD enters into contracts with qualifying members and thereby establishes the first layer of intermediation: the CSD holds the securities for the benefit of the qualifying members which are the first-layer custodians. Each qualifying member has an account at the CSD and the CSD credits each such account. The CSD can transfer securities between these accounts. This is only necessary where transactions between investors at the bottom of the pyramid (and the transactions between the intermediaries) do not net out at the intermediate layers of the system. The ability to net out transfer instructions at lower levels of the system provides rationalisation and is seen as a key benefit of this system.

Each first-layer custodian is bound by its own custody agreements with custodians further down the chain of intermediation, obliging the first-layer custodian to hold the position it is credited for the benefit of the custodian at the next layer. This process may repeat itself through a number of layers, with each sub-custodian holding the legal position (variable, depending on the applicable law) it enjoys vis-à-vis the higher-ranking custodian for the lower-ranking layer. The structure branches out ever further until the investor is reached. A chain of custody relationships thus connects the investor at the bottom of the "pyramid" to the CSD at the top.

In this web of contractual relationships, one frequently encounters the notion of account segregation. Here, the basic distinction is between account segregation (or not) at the CSD level on the one hand, and on the level of the (sub-)custodians on the other. There is a considerable overlay of regulation dealing with account segregation. Many of those rules came into effect as a result of the experience of the recent financial crisis (for a detailed exposition, we refer to *Costantini*, CapLaw-2012-40).

d) Cross-Border Securities Custody

The structure is more complicated when it comes to the cross-border settlement of securities transactions or the custody of securities across jurisdictions.

Clearstream Banking S.A. in Luxembourg (Clearstream) and Euroclear Bank in Belgium (Euroclear) are the two prominent cross-border service providers. They are referred to as *international central securities depositaries* (ICSDs). Clearstream and Euroclear do not hold securities directly in the same manner as CSDs. From the perspective of market participants, however, they perform a similar function. ICSDs enable the settlement of cross-border securities transactions by way of book-entry in their own accounts. ICSDs are therefore a specific type of sub-custodian facilitating the cross-border settlement of securities transactions by *internalising* these transactions (for an illustration involving US securities held for the benefit of the Central Bank of Iran, see the Factual Statement in the settlement agreement between the US Treasury Department's Office of Foreign Assets Control and Clearstream Banking S.A. of 22 January 2014). ICSDs can internalise large numbers of cross-border transactions in view of the large number of participants connected to them.

A CSD does not stand in isolation. There are numerous so-called CSD links. These CSD links also facilitate the settlement of transactions and the custody of securities in a cross-border context. Article 2 (29) Regulation (EU) No 909/2014 (CSDR) defines a CSD link as:

> *an arrangement between CSDs whereby one CSD becomes a participant in the securities settlement system of another CSD in order to facilitate the transfer of securities from the participants of the latter CSD to the participants of the former CSD or an arrangement whereby a CSD accesses another CSD indirectly via an intermediary.*

Another important category of undertakings involved in the cross-border safekeeping of securities is that of the *global custodian*. Where an investor holds a large, internationally diversified portfolio of securities, it may be impracticable for the investor to arrange for custody relationships to cover every market. From the perspective of such an investor, the global custodian acts as a single interface to these diverse systems of settlement and safekeeping. Global custodians operate proprietary and third-party custody networks spanning many jurisdictions.

The facts in two recent cases in the courts of England and Wales provide interesting illustrations of cross-border custody chains. In *Eckerle v Wickeder Westfalenstahl GmbH: [2013] EWHC 68 (Ch)*, the custody chain linking the German investors to the shares in DNick Holding plc involved Bank of New York Depository (Nominees) Limited as the registered shareholder and as sub-custodian for Clearstream AG. The rest of the German side of the custody chain was not fully reported. In *Secure Capital SA v Credit Suisse AG*, the chain involved RBS Global Banking (Luxembourg) SA as the investor's custodian, Clearstream as the sub-custodian and the settlement system, and Bank of New York Mellon holding the securities for Clearstream as a so-called common depository.

e) Basic Functional Requirements

Regardless of how national laws and legal doctrine translate this infrastructure into legal categories, there are a few universally acknowledged necessities, namely:

- the number of "shares in circulation" must match the number of shares on deposit at the central securities depository;
- the rules must provide legal certainty for the acquisition, disposal and hypothecation of securities and securities portfolios;
- an investor's assets must be insulated from the insolvency of the custodian;
- creditors should not be permitted to interfere with book-entries in securities accounts at higher levels of the securities intermediation pyramid; for an investor's general (attachment) creditors, the only object of attachment should be the investor's account at their custodian.

i. No Increase in Number of Shares (Phantom Shares)

In any given securities settlement and safekeeping system, the transactions between market participants and the activities of intermediaries must not result in an increase in the number of shares. Suppose that Corporation A has issued 10 million shares. At all times material, the number of shares "in circulation" in the system must be 10 million.

As we have outlined above, the shares issued by A are on deposit with a central securities depository. Strictly speaking, the number of A shares outstanding therefore cannot increase. What can theoretically increase beyond 10 million is the number of A shares credited by custodians to securities accounts at lower levels of the securities holding "pyramid": there is nothing to stop a custodian (if only accidentally) from crediting securities to a client's account.

This leads to an interesting contrast with money creation by banks. Most money in circulation is created by commercial banks. As is well known, commercial banks create money by crediting funds to their customers, e.g. when agreeing to lend them a certain sum of money. Whereas this is very much a socially desired outcome, the opposite is true in the securities markets. To preserve the integrity of the system, it is essential that custodians do not credit more securities to their customers than are held for them at the central securities depository, or than are credited to their account at the sub-custodian. One of the main causes for the crediting of *phantom shares* has been so-called naked short-selling, a practice dating back to the time of Joseph de la Vega and the Dutch Golden Age. In a naked short sale, the seller enters into the sale, but fails to avail himself of the means to deliver the share to the buyer. If the custodian of the buyer has already credited the buyer's account with the corresponding number of securities, a *settlement fail* may arise.

The notion of *phantom shares* is important in the context of our contribution, because it has been reported especially in the US securities markets and because it has been used as an argument in criticizing the US laws on intermediated securities founded on the concept of the *security entitlement*. It has on occasion been argued that *phantom shares* are the result of the legal foundation of the US post-trade infrastructure. In this system, investors no longer hold any title to the securities on custody, but instead acquire *security entitlements* only vis-à-vis their custodians. This kind of criticism insinuates that *phantom shares* cannot arise in systems which continue to attribute full legal title over the securities to the investor.

This claim is unfounded. Settlement fails (the technical events underlying the creation of *phantom shares*) are possible in all book-entry securities systems, regardless of the whether the applicable law conceives of the book entry in the investors' account as a security entitlement, another type of hybrid entitlement, or as "pure" property.

ii. Legal Certainty regarding Acquisition, Disposal and Hypothecation

Because securities are immobilised at a central securities depository, securities are acquired and disposed by way of book entry. For a plain vanilla sale, a credit to the buyer's account will have a matching debit in the sellers' securities account. The legal infrastructure must provide specifically for this practice. Alternatively, the existing rules must be sufficiently general in order to accurately capture the transfer of securities by way of book entry.

Of equal if not greater importance, the law must enable the creation of security interests in individual securities and entire portfolios of securities at acceptable cost. Hypothecation occurs at all layers of the highly dynamic modern securities systems, e.g. in the form of lombard facilities provided by banks to wealthy clients, where prime brokers provide leverage to their hedge fund clients against the hedge fund's portfolio, in the form of security interests taken by custodian banks over investors' assets etc. Transactions are large and frequent especially between intermediaries with no direct links to investors. They engage in large numbers of institutionalised and ad hoc-transactions which require the posting of collateral. All these practices require a legal infrastructure that enables the transfer and hypothecation not only of individual securities, but of entire securities portfolios, clear rules on the attachment and perfection of security title, and legal certainty with respect to finality of settlement.

iii. Insolvency Protection

The essential requirement in preserving confidence in the modern book-entry securities systems is to insulate the assets held for investors from the insolvency of their custodians and sub-custodians.

iv. No Upper-Tier Attachment

Turning from the custodian's general creditors to the attachment creditors of an investor, an important question is whether the latter should be allowed only to attach at the level of the investor's custodian, or whether they may initiate enforcement at higher levels of the securities holding pyramid (*upper-tier attachment*). There is broad international consensus that at each layer of the securities intermediation pyramid, the answer is no.

As we noted in our introduction, the systems of securities intermediation prevailing in the United States, Switzerland and most of the EU are *intransparent* systems. In such systems, a custodian at a higher level of the securities holding pyramid does not know whether a custodian at a lower level of the pyramid holds the securities for its own purposes or for another custodian at the bottom of the pyramid/an investor. Allowing for *upper-tier attachment* could result in the blocking of omnibus accounts by higher-level custodians and cause disruption in the system (settlement fails etc.).

3) Substantive Laws: The UCC Model

A fundamental distinction to be made in the US system is between the *legal owner* of securities on the one hand, and the *beneficial owner* on the other. The separation between legal and beneficial/equitable title is said to be alien to civil law jurisdictions, but commonplace in common law jurisdictions such as the laws of England and Wales and US laws. Crucially, there is no fixed notion of beneficial ownership that would apply across the board in all situations where the holder of legal title is different from the ultimate beneficiary.

Where securities must be registered (all US corporate laws mandate the issuance of registered shares), the entity recorded in the register and therefore the *legal owner* is Cede & Co., a nominee for the Depository Trust Company (DTC), the American central securities depository.

a) Security Entitlement

In the US context, to say that an investor is the beneficial owner of the securities should not lead one to think that the general property laws of the States apply. It was precisely to avoid this outcome that the UCC was drawn up. The position of the investor with respect to the securities is exhaustively covered by each State's legislation on investment securities mirroring or modelled on the UCC.

Under the UCC model, the investor is fully severed from the securities. The investor has no direct interest in the securities. The only legal position that an investor holds is a *security entitlement* vis-à-vis their custodian. As evidenced in the definition (U.C.C. § 8-102(a)(17)), the *security entitlement* is a hybrid concept incorporating contractual rights and a property interest:

> *"Security entitlement" means the rights and property interest of an entitlement holder with respect to a financial asset specified in Part 5.*

Pursuant to U.C.C. § 8-501(b), the investor (in U.C.C. parlance, the *entitlement holder,* cf. § 8-102(a)(7) acquires such *security entitlement* the moment a book entry is made to their *securities account* (U.C.C. § 8-501(a)) at a *securities intermediary* (U.C.C. § 8-102(a)(14)).

The *security entitlement* relates to a *financial asset.* The definition of a *financial asset* in U.C.C. § 8-102(a)(9) encompasses securities but extends to anything the *entitlement holder* and the *securities intermediary* agree to treat as a *financial asset*. The UCC model is radically functional (and, as we shall see, ideally suited to cross-border custody chains). Any asset the *entitlement holder* and the *securities intermediary* wish to deal with under the UCC model is thereby elevated to the status of a *financial asset*. In the words of the legendary James S. Rogers ((2007), 45 Can. Bus. L. J. 49, 55):

> *This provision captures a thought that only became apparent after considerable work on the UCC Article 8 revision project – that the rules of the indirect holding system were rules about how property is held, not what property is. In the quip that became part of the folklore of the UCC Article 8 revision project, the indirect holding system rules could just as well apply to a banana as to a bond. If a clearing corporation or other intermediary wishes to hold bananas for its customers as having the same package of rights with respect to those bananas as with respect to traditional securities held in the account, so be it.*

b) No Increase in the Number of Security Entitlements

The separation of the investor from the financial asset reflects the reality of the highly intermediated securities infrastructure. Since it is the *securities intermediary* that creates a *security entitlement* by way of book entry, safeguards need to be put in place to ensure that the number of *security entitlements* generated by the intermediaries will not exceed the number of *financial assets*. In the tradition of fruit analogies one might say that the *security entitlements* must not turn out to be lemons. U.C.C. § 8-504(a) reflects this concern, its wording again accounting for the reality of a multi-tiered chain of custody:

> *A securities intermediary shall promptly obtain and thereafter maintain a financial asset in a quantity corresponding to the aggregate of all security entitlements it has established in favor of its entitlement holders with respect to that financial asset. The securities intermediary may maintain those financial assets directly or through one or more other securities intermediaries.*

c) Insolvency Protection

What distinguishes the *entitlement holder* from a general creditor/depositor of the *securities intermediary* is that the *entitlement holder* enjoys a first priority claim to all interests in the *financial asset* that the *securities intermediary* acquires. This situation very much resembles a trust where the *entitlement holder* is the beneficiary and the *securities intermediary* act as the trustee. U.C.C. § 8-503(a) stipulates that:

> *To the extent necessary for a securities intermediary to satisfy all security entitlements with respect to a particular financial asset, all interests in that financial asset held by the securities intermediary are held by the securities intermediary for the entitlement holders, are not property of the securities intermediary, and are not subject to claims of creditors of the securities intermediary, (...)*

A crucial element not directly evident from the wording of this provision is that of timing: Even where a *securities intermediary* acquires the *interests* in the *financial asset* after having credited the *entitlement holder's* account, the interests will still be reserved for the *entitlement holder*. § 8-503(a) is a clear statutory allocation of risk for the benefit of the *entitlement holder* and to the detriment of general creditors.

As always, the wording of the U.C.C. model provisions allows for an infinite number of steps in the custody chain. The *interest in that financial asset* which the custodian or sub-custodian acquires may well be and frequently is a security entitlement vis-à-vis a sub-custodian.

d) Custodian as Sole Point of Contact

The investor's sole point of contact with the securities safekeeping infrastructure is the investor's custodian. All rights that the investor enjoys they may exercise only via the custodian. U.C.C § 8-503(c) stipulates that

> *An entitlement holder's property interest with respect to a particular financial asset under subsection (a) may be enforced against the securities intermediary only by exercise of the entitlement holder's rights under Sections 8-505 through 8-508.*

e) No Upper-Tier Attachment

In reality, there are several custodians between the investor and the security to which the investor's *security entitlement* relates. Under the UCC model, the custodian holds a *security entitlement* vis-à-vis the first sub-custodian, the first sub-custodian holds a *security entitlement* vis-à-vis the second sub-custodian, and so on. In this structure, upper-tier attachment is impossible. U.C.C. § 8-112(c) clarifies this for all levels of the securities holding pyramid:

> *The interest of a debtor in a security entitlement may be reached by a creditor only by legal process upon the securities intermediary with whom the debtor's securities account is maintained...*

f) Transfer

Given that the investor only holds a *security entitlement* with their custodian, it is not legally possible for the investor to transfer title to a security to another investor. Instead, the investor can only give an *entitlement order* to their custodian, which U.C.C. § 8-102(a)(8) defines as

> *a notification communicated to a securities intermediary directing transfer or redemption of a financial asset to which the entitlement holder has a security entitlement.*

As we have seen, the *financial asset* held by each (sub-)custodian (in UCC parlance, each *securities intermediary*) in the multi-tiered custody chain is itself a security entitlement. The only *securities intermediary* that holds actual title to the security and not merely a *security entitlement* is the *securities intermediary* at the top of the custody chain. That is the central securities depository. U.C.C. § 8-102(a)(14)(i) includes *a clearing corporation* in the definition of *securities intermediary*. The Depository Trust Corporation (DTC), the central securities depository in the United States, is a *clearing corporation* within the meaning of U.C.C. § 8-102(a)(14)(i).

Turning again to the bottom of the securities holding pyramid, an *entitlement order* originating from an investor results in an additional *entitlement order* by the investor's custodian to the first sub-custodian, a further *entitlement order* by the first sub-custodian to the second sub-custodian and so on. Such *entitlement orders* may net out at lower levels of the securities holding pyramid before reaching the level of the central securities depository.

As between an investor A disposing of their security and investor an B acquiring it, there is no transfer of title. This differentiates the UCC model from those jurisdictions which continue to ascribe title to the securities to the investor (French and German law in particular). U.C.C. § 8-104(a)(2) provides that, in the intermediated system, a security is acquired by a person when

> *the person acquires a security entitlement to the security pursuant to Section 8-501.*

It follows from U.C.C. § 8-501(b)(1) and U.C.C. § 8-501(b)(c) that investor B acquires a *security entitlement* by the simple fact of their custodian crediting their account, and irrespective of whether the transaction has settled.

This is at odds with the terminology generally used in the financial markets, including contractual documentation (*delivery*, *transfer* etc.). To avoid any problems of interpretation, the UCC provides a so-called translation rule. U.C.C. § 8-104(d) stipulates:

> *Unless the context shows that a different meaning is intended, a person who is required by law, regulation, rule or agreement to transfer, deliver, present, surrender, exchange, or otherwise put in the possession of another person a security or financial asset satisfies that requirement by causing the other person to acquire an interest in the security or financial asset pursuant to subsection (a) or (b).*

g) Hypothecation

The rules for establishing security interests over security entitlements are contained in U.C.C. Article 9 – Secured Transactions. There are various ways in which security interests over security entitlements can be perfected. Of these, *automatic perfection* of security interests created by brokers and securities intermediaries pursuant to U.C.C. §§ 9-310(b)(2), 9-309(10) and *perfection by control* of security entitlement pursuant to U.C.C. §§ 9-310(b)(8), 9-314(a), 9-106(a) and 8-106(d) are particularly important for the intermediated securities system and wholesale collateral management.

h) Cross-Border Holdings

To illustrate the advantage of the UCC model in a cross-border context, consider the situation of a German investor wanting to acquire shares in an American company through their overseas custodian. In a domestic setting, German law would treat the investor as legal owner, assigning a special type of joint title to a pool of securities on deposit at the central securities depository. In a cross-border setting with the US, that is not possible. The legal owner of the shares is Cede & Co, the DTC's nominee. The entity linking the German securities infrastructure to the US securities infrastructure cannot have itself registered as the shareholder. Something has to give. Unsurprisingly, German law provides specific rules for the custody of foreign securities.

Under the UCC model, there is no need to differentiate the statutory provisions even further. An American investor seeking exposure to overseas securities through a domestic custodian will acquire, by way of book entry to their account at that custodian, a *security entitlement*. In all likelihood, their *security entitlement* will be covered by another *security entitlement* that their custodian holds at its sub-custodian, and so on. At each layer, the *financial asset* reveals itself to be another *security entitlement*. The only entity that holds a *financial asset* that is not a *security entitlement* is the entity linking the US securities infrastructure to the overseas securities infrastructure. Regardless of the legal nature of the interest that entity holds, the domestic situation remains unchanged. From the investor's point of view, the situation is only marginally different where the link to the foreign securities infrastructure is established via American Depository Receipts (ADRs).

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New Rules for Organized Trading Facilities

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While the concept of organized trading facilities has been introduced into Swiss law more than one and a half year ago, many of the rules applying to organized trading facilities will only be phased in by the beginning of 2018. Similarly, the Swiss regulator, the Swiss Financial Market Supervisory Authority FINMA, has only recently published regulatory guidance on the rules applicable to organized trading facilities. Such rules and regulatory guidance will start applying from January 1, 2018.

By Patrick Schleiffer / Patrick Schärli

1) What is an Organized Trading Facility?

With the enactment of the Financial Market Infrastructures Act (“**FMIA**”) and its implementing ordinance (“**FMIO**”) in the beginning of 2016, the Swiss regulatory framework applicable to trading platforms was significantly changed. Under the previous rules, Swiss law categorized trading platforms into exchanges (e.g. SIX Swiss Exchange, Eurex Zurich) and other trading platforms (referred to as “börsenähnliche Einrichtungen”). The latter category included all kinds of trading platforms that—while having similar functionalities than an exchange—did not meet all the criteria to qualify as an exchange. These other trading platforms were regulated on a case by case basis by FINMA with some platforms being essentially regulated like an exchange (e.g. BX Berne Exchange) and with other platforms not being regulated at all. Under the FMIA, trading platforms now fall into one of the following three categories: exchanges, multilateral trading facilities, and organized trading facilities (“**OTF**”).

Unlike under European law, the Swiss law OTF category serves as a rather wide catch-all category and encompasses the following types of trading platforms:

- Multilateral trading platform that allow for trading in securities within the meaning of the FMIA (i.e. standardized financial instruments which are suitable mass trading) and other financial instruments based on discretionary rules;
- multilateral trading platforms on which financial instruments other than securities (such as OTC derivatives) can be traded based on non-discretionary rules; and
- bilateral trading platforms. According to the recent FINMA circular on OTF ("**FINMA Circular 18/1**"), trading is considered bilateral if and when the operator of an OTF acts as counterparty and thus takes a market risk.

Conversely, under Swiss law, a multilateral trading platform on which securities (within the meaning of the FMIA) can be traded based on non-discretionary rules would have to be set up as a multilateral trading facility ("**MTF**").

Under the FINMA Circular 18/1, trading rules are deemed to be discretionary if the operator of an OTF has discretion to place an order through, or withdraw it from, an OTF, or not to match an order with another order, or, in case of a bilateral trading platform, to enter or not enter into an agreement with its counterparty.

It is noteworthy that under Swiss law the activity of a so-called systematic internalizer would be captured as an OTF (more specifically, as a bilateral trading platform). The proper categorization of an OTF as a multilateral system or a bilateral system is important as the Swiss rules on OTF make a clear distinction between obligations that apply to multilateral OTF and obligations that apply to bilateral OTF.

Given the rather wide scope of the term OTF, FINMA Circular 18/1 also provides for regulatory guidance on what is actually considered an OTF and what falls outside of the scope of the term OTF. For example, FINMA Circular 18/1 specifically excludes e.g. bulletin boards, order routing facilities and indicative pricing facilities from the scope of application of the Swiss OTF rules.

2) Which Organized Trading Facilities Fall within the Scope of the Swiss Rules?

The Swiss OTF rules generally apply to all Swiss OTF, i.e. OTF that are (i) directly operated by a Swiss financial institution (i.e. licensed bank, securities dealer or financial market infrastructure), or (ii) operated by a non-Swiss operator and that has at least a technical presence in Switzerland (e.g. server infrastructure). Non-Swiss OTF that do not have a technical presence in Switzerland are not subject to the Swiss OTF rules.

In our view this is also true where a non-Swiss OTF voluntarily seeks for a recognition from FINMA.

Further, where an OTF is operated by a Swiss licensed bank, securities dealer or a licensed trading venue through a non-Swiss branch or a non-Swiss subsidiary, such OTF is in our view also not subject to the Swiss OTF rules. However, in such a case, FINMA expects that the Swiss bank, securities dealer or trading venue has put in place appropriate measures allowing them to identify, monitor and mitigate the risks related to such OTF.

3) What Rules Apply to Organized Trading Facilities in Switzerland?

Unlike exchanges or multilateral trading facilities, OTF are not independently authorized financial market infrastructures. Rather, operating an OTF is an activity that is only open to certain already licensed financial market players. I.e., only Swiss licensed banks and securities dealers as well as authorized or recognized trading venues (i.e. operators of an exchange or an MTF) are permitted to operate an OTF in Switzerland.

While not being subject to separate licensing requirements, financial institutions that wish to operate an OTF have to comply with a specific set of rules, including organizational measures, prevention of conflicts of interests, guarantee of orderly trading and pre- and post-trading transparency. Also, FINMA has to be notified of the fact that an OTF is being operated or that the operation of an OTF is being contemplated in the future.

a) Organizational Measures

The Swiss rules require that an operator of an OTF puts in place adequate internal regulations allowing it to monitor trading operations and compliance with rules and regulations. For this purpose, the operator of an OTF must also keep a chronological record of orders and transactions carried out through its platform.

In addition, the FMIA stipulates the following three guiding principles regarding the organization of an operator of an OTF:

- The operation of the OTF needs to be separated from the other business activities of the OTF operator;
- the operator of the OTF must take effective organizational measures to identify, prevent, settle and monitor conflicts of interest; and
- the operator of an OTF must ensure that client interests are comprehensively protected when conducting proprietary transactions on the OTF.

The Swiss regulator FINMA has further specified these principles in its FINMA Circular 18/1. In this circular, FINMA also makes a distinction between rules that apply to multilateral OTF and rules that apply to bilateral OTF:

– *Multilateral OTF:* FINMA Circular 18/1 requires that operators of OTF not only separate the OTF part of their business from its other business activities, but that they also operatively separate multiple OTF (if such an operator runs multiple OTF) from each other. In particular, a transfer of orders between bilateral functions and multilateral functions must be prevented by putting in place appropriate and effective measures. Further, operators of OTF must avoid conflicts of interest by not carrying out own-account trading (bilateral OTF) and matched principal trading (multilateral OTF) on the same trading platform.

  Where the relevant OTF allows for transactions to be carried out based on discretionary rules, best execution must be guaranteed, provided the relevant platform participant has not expressly waived this right.

  FINMA further specifies what it considers to be "appropriate and effective measures" for achieving operational separation. According to FINMA Circular 18/1 such measures include the use of rooms, personnel, functions, organization and information technology to identify, prevent, eliminate and monitor conflicts of interest and to create confidential spaces in which information can be isolated and controlled. Further, FINMA expects that the persons who trade in securities or financial instruments or decide on such trading must not be allowed to make any decisions regarding the ongoing operation of the OTF.

– *Bilateral OTF*: While operators of multilateral OTF are subject to stringent operational separation requirements, FINMA's focus is a different one when it comes to operators of bilateral OTF. Here, FINMA's primary focus is transaction transparency and mitigation of potential conflicts of interests. More specifically, FINMA Circular 18/1 requires that operators of bilateral OTF must ensure that each order is executed at the price valid when the order was received or at a better price for the participant. In other words, the operator of a bilateral OTF must generally ensure that the best possible result is achieved for the participant financially as well as in terms of timing and quality. Exceptions from this best execution requirement are permitted if the relevant client has expressly waived its right to best execution for a specific transaction or issues clear instructions.

  Where an operator of a bilateral OTF creates specific financial instruments for its clients and then provides repurchase prices for such financial instruments, the OTF operator must ensure that the repurchase prices are reasonable in relation to the products' underlying assets.

The operator of a bilateral OTF must show to its participants, on request, that their orders have been executed in accordance with the rules established by the platform.

b) Guarantee of Orderly Trading

The FMIA subjects operators of an OTF to an obligation to guarantee orderly trading. More specifically, the FMIA requires that operators of an OTF must ensure orderly trading even in the event of intense trading activity and that the operator of an OTF must take effective measures to prevent disruptions to the trading facility. The FMIO further specifies that in order to ensure orderly trading, an operator of an OTF has to do the following:

- Set and implement transparent rules and procedures for fair, efficient and orderly trading, as well as objective criteria for the effective execution of orders;
- put in place measures to ensure the robust management of technical processes and the operation of its systems, including, (i) ensuring that its system has sufficient capacity to deal with peak volumes of orders, (ii) ensuring trading under conditions of severe market stress, (iii) having in place disruption recovery processes, and (iv) being able to reject, cancel, amend or correct certain orders and transactions or halt trading in case of significant short-term price movements;
- enter into written agreements with all of its participants holding a special function (e.g. market makers); and
- put in place effective measures relating to algorithmic trading and high-frequency trading in order to prevent disruption of trading on the OTF. This includes the capability to identify such transactions and requirements for participants to flag their transactions.

Pursuant to FINMA Circular 18/1 an operator of an OTF has to enact regulations on the organization of trading and monitor compliance with applicable rules and regulations. Operators of an OTF should further set up an efficient control function that is independent of trading and systematically records and evaluates trading data without interruption and must integrate this into its internal control system.

c) Pre-Trade Transparency

As described below, the FMIA provides for a post-trading transparency duty applying to OTF. Further, the FMIA empowers the Swiss government to also put in place pre-trading transparency obligations in line with internationally recognized standards. The Swiss government did so by including appropriate provisions in the FMIO.

For the time being, an OTF's pre-trade transparency obligations only relate to shares. Other financial instruments, such as bonds, structured products, are not subject to the pre-trade transparency.

The pre-trade transparency rules apply to multilateral OTF and bilateral OTF with a liquid market. According to FINMA Circular 18/1, a market for a financial instrument is regarded as being liquid if the financial instrument in question was traded at least 100 times per trading day on average in the previous year on the trading venue (i.e. exchange or MTF) to which it was first admitted. Thus, if a financial instrument is not admitted to trading on a trading venue, no liquid market exists in such financial instrument for purposes of FINMA Circular 18/1.

Finally, under the FINMA Circular 18/1, a bilateral OTF can meet the pre-trade transparency requirements by publishing binding offers only. If no liquid market exists for a particular financial instrument, it is sufficient to provide price offers on request only.

d) Post-Trade Transparency

Unlike the pre-trade transparency, the post-trade transparency generally applies to transactions in all kinds of financial instruments conducted on an OTF. Like it is the case with other obligations, the Swiss post-trading transparency rules make a distinction between multilateral OTF and bilateral OTF:

- *Multilateral OTF*: As a general rule, the platform needs to but in place regulations and processes allowing for the publication of information regarding the price, volume and time of transactions as soon as possible. Transactions that were carried out outside of trading hours need to be published by the start of the following trading day. Publication delays are permissible in certain cases and if the platform has provided for such publication delays in its rules and regulations.

- *Bilateral OTF*: Bilateral OTF have lighter post-trading transparency rules. Here, it is sufficient to publish aggregated trade information at the end of each trading day.

4) When Do the Swiss Rules Start to Apply?

There are two different starting points for the obligations that apply to OTF. First, the organizational measures, including the prevention of conflicts of interests apply ever since the entry into force of the FMIA in the beginning of 2016. However, the regulatory guidance relating to these obligations as set out in FINMA Circular 18/1 will become effective only on January 1, 2018. Second, the rules regarding pre- and post-trading transparency, algorithmic trading and high frequency trading and most of the other aspects of the duty to ensure orderly trading (e.g. flagging of short sales, written agreements with special participants (such as market makers), technical measures (e.g. emergency measures, order rejection and the like), have to be complied with no later than January 1, 2018.

5) Conclusion

Operators of Swiss OTF will have to make sure that they are ready for complying with the various new rules that will be in full force and effect starting from January 1, 2018. More specifically, the OTF operators should review their regulation and update them accordingly in order to keep track of the various new obligations (e.g. with respect to algorithmic trading). Further, OTF operators need to review and, if necessary, adapt their internal organization in order to keep up with the additional organizational requirements (e.g. operational separation, control functions) that will be put on them starting from next year. Finally, OTF operators need to put in place appropriate processes to handle pre- and post-trade transparency. This includes enacting regulations and, on a more technical level, defining how and in what format data will have to be delivered and subsequently published.

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The Financial Stability Board published its Guiding Principles on iTLAC

Reference: CapLaw-2017-45

On 6 July 2017, the Financial Stability Board published its guiding principles on the loss-absorbing resources to be committed to subsidiaries or sub-groups that are located in host jurisdictions and deemed material for the resolution of a G-SIB as a whole (iTLAC). The guiding principles support the implementation of the iTLAC requirement in each host jurisdiction and provide guidance on the size and composition of the iTLAC requirement, cooperation and coordination between home and host authorities and the trigger mechanism for iTLAC.

By René Bösch / Benjamin Leisinger / Lee Saladino

On 9 November 2015, the Financial Stability Board (the FSB) released the Principles on Loss-absorbing and Recapitalisation Capacity of global systemically important banks (G-SIBs) in Resolution (the TLAC Principles), together with a Total Loss-absorbing Capacity (TLAC) term sheet implementing these principles (the TLAC term sheet). Although the TLAC term sheet is largely focused on so-called "external TLAC", section 16 et seqq. of the TLAC term sheet sets forth basic elements of the purpose, general size and core features of internal TLAC (iTLAC), *i.e.*, the loss-absorbing resources to be committed by a G-SIB's resolution entity or entities (which is, in the case of a single-point-of-entry (SPoE) resolution strategy, the ultimate holding company) to its subsidiaries or sub-groups located in host jurisdictions and deemed material for the resolution of the G-SIB as a whole (Material Sub-Groups).

On 6 July 2017, following a consultation based on a draft issued by the FSB on 16 December 2016, the FSB issued the final Guiding Principles on the Internal Total Loss-absorbing Capacity of G-SIBs (the iTLAC Guiding Principles). These high-level principles are designed to assist authorities that are part of a G-SIB's Crisis Management Group (CMG) in the implementation of iTLAC mechanisms consistent with the TLAC term sheet. The responsible regulatory authority in a G-SIB's "home country" (Home Authority) and the authorities in the foreign jurisdictions in which the G-SIB has a presence (Host Authorities) are expected to take the iTLAC Guiding Principles into account when identifying Material Sub-Groups and when establishing the iTLAC requirements and trigger mechanisms applicable to such Material Sub-Groups.

1) Subject-Matter of the iTLAC Guiding Principles

The iTLAC Guiding Principles consist of five major parts: Material Sub-Group identification and composition (part I.), the size of the iTLAC requirement (part II.), the composition and issuance of iTLAC (part III.), features of trigger mechanisms for iTLAC (part IV.), and the home-host process for triggering iTLAC (part V.). Each of these five parts contain guiding principles on the respective topic.

a) Material Sub-Group Identification and Composition

The process for identifying Material Sub-Groups consists of several coordinated steps between the Home Authority and the Host Authorities and, in certain cases, the CMG.

The Home Authority initiates the process by identifying Material Sub-Groups based on group-level information to which it has access. Taking into account the Home Authority's proposed list of Material Sub-Groups, each Host Authority should then identify a Material Sub-Group in its jurisdiction, in consultation with the Home Authority and the CMG. If a subsidiary or sub-group has been identified as a Material Sub-Group based solely on a determination that it exercises critical functions for the G-SIB, rather than based on one of the quantitative criteria set forth in Section 17 a.-c. of the TLAC term sheet, such subsidiary's or sub-group's inclusion in the list of Material Sub-Groups requires the consent of the CMG. Once a resolution entity's Material Sub-Groups have been identified as a result of this process, the Home Authority and the Host Authorities that are members of the CMG should review the list of Material Sub-Groups on an annual basis.

A similar process exists to determine whether a subsidiary or sub-group no longer qualifies as a Material Sub-Group: In the annual review, the Home Authority may provide evidence that a subsidiary or sub-group should no longer be identified as material for purposes of the iTLAC requirement, *i.e.*, is no longer a Material Sub-Group. The relevant Host Authority would then have the opportunity to provide evidence to the contrary. However, the ultimate decision as to whether such subsidiary or sub-group remains a Material Sub-Group lies with the Host Authority following consultation with the Home and other Host Authorities that are members of the CMG, and is subject to the consent of the CMG if such subsidiary or sub-group's designation was based on a determination that it exercises critical functions for the group as a whole.

For so long as a subsidiary or sub-group qualifies as a Material Sub-Group, the relevant Host Authority determines, in consultation with the Home Authority and the CMG, the composition of the Material Sub-Group (taking the existing scope of regulatory or accounting sub-consolidation as a starting point), and the distribution of iTLAC among the entities that form the Material Sub-Group. When making such determination, the resolution strategy of the G-SIB should be supported by facilitating the stabilization of the relevant entities within the Material Sub-Group through the passing of losses and recapitalization needs of the Material Sub-Group on to the resolution entity (*i.e.*, in the case of an SPoE resolution strategy, the ultimate holding company).

As a principle, the composition of Material Sub-Groups should be limited to subsidiaries located in a single jurisdiction. Exceptionally, if the CMG agrees that it is necessary to support the agreed resolution strategy of the G-SIB and to ensure that iTLAC is appropriately distributed within the Material Sub-Group, Material Sub-Groups may consist of entities located in more than one jurisdiction, so long as there is a single resolution regime covering those jurisdictions or a high degree of cooperation and coordination between the Host Authorities in those jurisdictions.

The decision to include (or not include) any regulated or unregulated non-bank entity in a Material Sub-Group should be based on the resolution strategy for the G-SIB and an assessment of the risk that the entity could generate losses and would need to be recapitalized.

b) Size of the iTLAC Requirement

The responsibility – and authority – for setting the iTLAC requirements for the Material Sub-Groups in their jurisdiction lies with the Host Authorities, following consultation with the Home Authority.

As a guiding principle, the iTLAC requirement for a particular Material Sub-Group should be scaled within the 75%-90% range of the external minimum TLAC requirement that would apply to the Material Sub-Group if it were a separate resolution group, as calculated by the Host Authority, consistent with the TLAC term sheet. When fixing the exact requirement, a Host Authority should take into account (i) the purpose of iTLAC to ensure that there is sufficient iTLAC to cover the loss-absorption and recapitalization needs of the Material Sub-Group and to support the agreed resolution strategy for the resolution group, and (ii) that the requirement will have implications for the resolution group, *e.g.*, by limiting the resolution entity's flexibility to use loss-absorbing capacity within the resolution group where and when needed as required by principle (vi) of the TLAC Principles.

Unfortunately, however, while the iTLAC Guiding Principles acknowledge that it shouldn't be the case, they explicitly contemplate (and permit) a scenario in which the sum of the iTLAC requirements set by Host Authorities for a resolution entity's Material Sub-Groups exceeds such resolution entity's external TLAC requirement, which may cause an increase in the resolution entity's external TLAC (iTLAC Guiding Principle 6). If a resolution entity's aggregate iTLAC requirements were to exceed its external TLAC requirement after taking into account consolidation effects, the Home Authority – absent any downward adjustment in the iTLAC requirements by Host Authorities – would need to take action to ensure that the resolution entity has sufficient external TLAC (*i.e.*, increase the external TLAC requirement). In other words, by setting the iTLAC requirements in their respective jurisdictions, Host Authorities are indirectly able to increase the external TLAC requirement that would otherwise be applicable to a resolution authority pursuant to the TLAC Principles, the TLAC term sheet and, potentially, the national regulations implementing the foregoing in the Home Authority's jurisdiction. In our view, this ability runs counter to the very purpose of iTLAC, which has as its primary objective the facilitation of co-operation between Home and Host Authorities (Section 17 of the TLAC term sheet). When Host Authorities choose to set the iTLAC requirement so high that the requirement also drives the amount of the resolution entity's external TLAC requirement, they may eventually lose the incentive to co-operate with the Home Authority in times of a crisis to the extent that they need little to no outside assistance to recapitalize their Material Sub-Groups.

If there are proceeds of external TLAC that are neither distributed to Material Sub-Groups – despite the problem identified in the preceding paragraph – nor required to cover risks on the resolution entity's solo balance sheet (so-called Surplus TLAC), it should be readily available to the resolution entity so that it can be used to recapitalize any direct or indirect subsidiary when needed. In order to ensure this, Home Authorities should consider the characteristics of the corresponding assets in which such Surplus TLAC is invested to ensure that it is readily available and that there are no legal and operational barriers to using it to recapitalize a resolution entity's subsidiaries. For example, the iTLAC Guiding Principles mention that Home Authorities may consider it appropriate for Surplus TLAC to be invested in assets that can be promptly and easily valued and that are likely to retain sufficient value in times of market-wide stress.

G-SIBs are expected to meet the iTLAC requirement as from the date when they are expected to comply with the TLAC sheet and implement the minimum external TLAC requirement as provided in section 21 of the TLAC term sheet. This means that G-SIBs designated by the FSB as such before the end of 2015 and that continue to be designated as such thereafter, must meet the iTLAC requirement by 1 January 2019. If during the iTLAC implementation period or thereafter a new Material Sub-Group is identified, for example due to an acquisition or operational changes, such new Material Sub-Group must meet the iTLAC requirement within 36 months from the date of its identification as a Material Sub-Group, or within an appropriate shorter period as determined by the relevant Host Authority in consultation with the Home Authority.

c) Composition and Issuance of iTLAC

When determining the composition of iTLAC, *i.e.*, in which form iTLAC may be issued by a Material Sub-Group, a Host Authority should consult with the Home Authority, including on the impact of the composition on the credibility and sustainability of the resolution strategy of the G-SIB and the ability of the Material Sub-Group to effectively pass losses and recapitalization needs of the Material Sub-Group on to the resolution entity.

The general expectation under the iTLAC Guiding Principles is that at least 33% of a Material Sub-Group's iTLAC requirement will consist of debt liabilities. The reason being, *inter alia*, because iTLAC in the form of equity could result in a scenario in which the resolution entity is unable to finance its interest payments on its external TLAC debt because it has not earned sufficient dividend payments on iTLAC in the form of equity.

Notwithstanding this expectation, at the time a Material Sub-Group must begin to comply with its iTLAC requirement, it will likely already have equity and other instruments in place that may be counted towards satisfying such requirement. Accordingly, the composition of a Material Sub-Group's existing iTLAC, if any, and the practicality of making changes to it, should be taken into account. In other words, a Material Sub-Group should not be required to issue additional iTLAC beyond the requirement set by the Host Authority, if it has initially met the quantitative but not the qualitative requirements set out in the iTLAC Guiding Principles (or national law implementing such principles in the Host Authority's jurisdiction).

Home and relevant Host Authorities may also jointly agree to substitute on-balance sheet iTLAC with iTLAC in the form of collateralized guarantees, subject to the conditions in Section 19 of the TLAC term sheet. The iTLAC Guiding Principles contain several considerations that Home and Host Authorities should take into account when determining if the conditions for using of collateralized guarantees that are set out in Section 19 of the TLAC term sheet have been met.

When deciding which entity in the Material Sub-Group should issue iTLAC to which resolution group entity, it is of paramount importance to credibly support the resolution strategy of the G-SIB and to ensure that the losses and recapitalization needs of the Material Sub-Group will be passed on to the resolution entity. One way of ensuring this is by issuing back-to-back iTLAC through multiple legal entities in the chain of corporate ownership (so-called daisy chain), starting with the resolution entity.

The iTLAC Guiding Principles also discuss the law applicable to iTLAC. According to Guiding Principle 11, iTLAC should generally be subject to the governing law of the jurisdiction in which the Material Sub-Group entity issuing the iTLAC is incorporated or formed. However, iTLAC may instead be governed by or be otherwise subject to the laws of another jurisdiction if, under those laws, the application of resolution tools by the relevant Material Sub-Group's Host Authority, or the write-down or conversion into equity of such iTLAC by such Host Authority, is effective and enforceable under the laws of such other jurisdiction on the basis of binding statutory provisions or legally enforceable contractual provisions for the recognition of the exercise of such Host Authority's resolution tools and statutory write-down powers.

d) Features of Trigger Mechanisms for iTLAC

Section 19 of the TLAC term sheet stipulates that iTLAC must be subject to a write-down and/or conversion into equity by the relevant Host Authority at the point of non-viability, as determined by such Host Authority in line with the relevant legal framework, without entry of the issuing entity into statutory resolution proceedings. In addition, it states that any such write-down or conversion is subject to obtaining the consent of the Home Authority, unless the relevant iTLAC instrument is a regulatory capital instrument.

According to iTLAC Guiding Principle 13, Home and Host Authorities should consider if the extent of the write-down and/or conversion into equity of iTLAC (*i.e.*, full or partial) and the length of the period the Home Authority will be granted to provide its consent to any such write-down and/or conversion into equity should be incorporated into the trigger conditions set forth in the relevant iTLAC instrument or agreed separately. In particular, the benefits of greater specificity in the iTLAC instrument itself should be weighed against the potential risks of constraining the flexibility of Home and Host Authorities in times of crisis.

e) The Home-Host Process for Triggering iTLAC

The process for triggering a write-down or conversion into equity of iTLAC within a Material Sub-Group consists of several stages:

– *First*, the Home and relevant Host Authority should communicate regarding the condition of the Material Sub-Group. This ensures that the Home and Host

Authority have the opportunity to consider alternative options to restore the Material Sub-Group's viability (including through application of measures contemplated in the G-SIB's recovery plan) and, most importantly in the case of an SPoE resolution strategy, allows the Home Authority, if necessary, to prepare for the potential resolution of the resolution entity. The Home Authority should inform the CMG of any actions it plans to take to restore the Material Sub-Group's viability.

– *Second*, the Host Authority should determine whether some or all of the iTLAC within the Material Sub-Group should be triggered. iTLAC should be triggered only as a last resort, if and to the extent that no credible alternative options are available to restore the Material Sub-Group's viability in an appropriate timeframe (including, in the case of an SPoE resolution strategy, the option to recapitalize the Material Sub-Group top-down). In any event, under no circumstances should iTLAC be hard-wired to automatically trigger if resolution proceedings with respect to the resolution entity are opened or if a write-down and/or conversion into equity of TLAC occurs elsewhere in the resolution group (including the triggering of iTLAC in another Material Sub-Group). Pursuant to Section 19 of the TLAC term sheet, the consent of the Home Authority is required for the triggering of non-regulatory capital instruments that are used to meet iTLAC requirements. If the Home Authority objects to the write-down and/or conversion into equity of any such iTLAC instrument, or does not provide its consent within the – ideally – ex ante agreed timeframe, the Host Authority may choose to apply its own resolution bail-in or other resolution powers to the Material Sub-Group. However, iTLAC Guiding Principle 17 emphasizes that this should be avoided to the greatest extent possible.

– *Third*, the Host Authority must determine the capital shortfall with respect to the Material Sub-Group and the extent of recapitalization required. At a minimum, a sufficient amount of iTLAC will have to be written-down and/or converted into equity so that the Material Sub-Group will meet the jurisdiction's regulatory capital requirements (*e.g.*, the minimum Basel III capital requirements and firm-specific additional requirements, if any). When deciding between a write-down and a conversion of into equity, changes in the control of the Material Sub-Group and material risks of legal challenge should be taken into account.

2) Critical Assessment

In our view, two features of iTLAC are of paramount importance: First, the iTLAC requirement set by a Host Authority must predominantly "facilitate co-operation between Home and Host Authorities" (Section 16 of the TLAC term sheet) and, second, there must be sufficient flexibility to use loss-absorbing capacity within a G-SIB group where and when it is needed and there must be credible mechanisms in place to be able – with legal certainty – to pass losses on to the resolution entity and meet the recapitalization needs of members of the resolution group (Section 18 of the TLAC term sheet). Host Authorities should themselves be interested in the resolution entity (*i.e.*, in the case of an SPoE resolution strategy, the ultimate holding company) having sufficient flexibility to use loss-absorbing capacity where needed: if the resolution entity's operations in their jurisdiction experience a "black swan event", instead of being limited to the pre-deployed/prepositioned loss-absorbing capacity in their jurisdiction (which may not be sufficient to recapitalize the relevant Material Sub-Group), they could benefit from the additional "free" loss-absorbing capacity-resources available to the resolution entity.

While the iTLAC Guiding Principles provide for a good basis and contain valuable concepts for iTLAC of G-SIBs, we believe that certain elements could jeopardize the very concept underlying iTLAC, which is to facilitate co-operation between Home and Host Authorities and to maintain sufficient flexibility to use loss-absorbing capacity within a G-SIB group where and when it is needed. In particular:

– The iTLAC Guiding Principles still leave room for separate or supplementary local TLAC requirements to be instituted in addition to iTLAC (see footnote 6 of the iTLAC Guiding Principles); such local requirements would substantially limit the comparability of iTLAC requirements between jurisdiction and could undermine the international standard;

– The iTLAC Guiding Principles mention that Host Authorities may, in certain circumstances, introduce additional firm-specific iTLAC requirements (see Guiding Principle 5); the ability of a Host Authority to introduce such additional requirements and, thereby, increase the resources available to it to recapitalize the Material Sub-Group in its jurisdiction could limit the Host Authority's incentive to co-operate with the Home Authority in times of crisis to the extent that it needs little to no outside assistance to recapitalize such Material Sub-Group; and

– The external TLAC requirement applicable to a resolution entity does not function as a ceiling on the aggregate iTLAC requirements set by the Host Authorities or influence the calibration by a Host Authority of the iTLAC requirement applicable to the Material Sub-Group in its jurisdiction within the 75%-90% range (see Guiding Principle 6); if a resolution entity's external TLAC requirement is not used to set the upper limit for the aggregate iTLAC requirements set by Host Authorities, there is no "corrective" in place to limit the Host Authorities' appetite for iTLAC and to ensure that they are properly incentivized.

It remains to be seen to what extent the Host Authorities make use of the above-mentioned critical aspects. The authors' hope is that the discussions in the CMGs and the close cooperation between their members prior to a crisis will lay the groundwork for mutual trust and that this trust – even more than the "insurance" intended to be created by iTLAC – will facilitate cooperation between Home and Host Authorities in times of crisis and help to maintain sufficient flexibility to use loss-absorbing capacity within a G-SIB group where and when it is needed.

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Rising Popularity of Reverse Break Fees and Legal Challenges for Swiss Bidders

Reference: CapLaw-2017-46

Reverse break fees are becoming more and more popular in private but also public M&A deals. Compared to Switzerland, reverse break fees are often significantly higher in the US. The Swiss Takeover Board is limiting direct break fees in public offers. Reverse break fees, however, are not subject to any ex ante official control and might, therefore, expose the board members of target companies to ex post challenges.

By Urs Kägi / Daniel Küpfer

1) Introduction

In public M&A deals, bidding and target companies often agree on payments for the event that the deal cannot close. Direct break fees are payments from the target to the bidder. In turn, payments from the bidder to the target are called reverse break fees. Both types of break fees serve to protect the deal against risks in connection with a proposed takeover and to control parties' behavior.

The original function of (direct) break fees was to compensate the bidder for its expenses, which became useless after the target or its shareholders accepted a subsequent and higher offer after an agreement with the first bidder. However, to extent allowed under applicable law, break fees can also take on the function of deal protections, given that considerable time may elapse between the signing and the closing.

Conversely, reverse break fees compensate the target if the deal is not carried out because of issues that are either the bidder's responsibility (such as the lack of approval of its shareholders), or are outside of both parties' control (such as the refusal of regulators to grant merger approval). On the other hand, a reverse break fee, particularly if it is designed as a walk-away right, can be seen as the price for the bidder's option not to complete the transaction. Compared to (direct) break fees, reverse break fees are typically significant higher, and because they do not affect competition between bidders, are generally less heavily regulated.

2) The US market

Originating in US private equity deals in the early 1980s, break fees and reverse break fees have become the market standard in public M&A deals around the world. US market standard reverse break fees are between three and six percent of the transaction value, depending on the trigger event. Especially for failure of antitrust approvals, we have seen reverse break fees climbing up to 40% of the transaction value. In absolute terms, the largest reverse break fee ever agreed was, to our knowledge, $10 billion after Verizon Communications acquired Vodafone's 45% interest in Verizon Wireless.

Most recent studies in the US, however, show that average break fees and reverse break fees are more modest. In 2015, median values of reverse break fees were equal to 2.00% of the equity value for general breach, 4.30% for antitrust failure, and 6.94% for financing failure. The median of direct break fees, on the other hand, amounts to 3.45% of the equity value. Compared to 2014, both types of fees slightly increased. Alongside this development, also the number of deals which use break fee triggers is rising, which is probably due to the ever longer duration of transactions, among other things. To the extent already available, in 2016 both the overall average reverse break fees and overall average direct break fees appear to have slightly decreased by 0.3% and 0.1% to 5.2% and 3.5%, respectively, compared to 2015.

An illustrative example is AT&T. After having paid about $6 billion (15.4% of the transaction value) to T-Mobile in 2012 for the failure to obtain necessary antitrust approvals, AT&T considered in its 2016 acquisition of Time Warner that break fees are less relevant. If the deal does not go through for antitrust reasons, AT&T will have to pay Time Warner only $500 million, which is less than 0.6% of the $85.4 billion transaction value. Conversely, Time Warner agreed to pay a $1.7 billion break fee. A more recent (but less extreme) example is the 2015 announced merger between Staples and Office Depot which has been blocked for antitrust reasons. Staples finally paid a $250 million termination fee (4% of the transaction value) to Office Depot.

3) Swiss public M&A

a) Swiss precedents

In Switzerland, direct break fees are more common than reverse break fees. In the past 17 years, the median break fee in public M&A deals (conducted as a public offer) was equal to 0.66% of the transaction value, which is slightly below the arithmetic average of 0.88%.

The reason for these comparatively small figures is that the Swiss Takeover Board only accepts fees that correspond to the estimated bidder's actual costs. The Swiss Takeover Board highlighted in its decisions that there is no fix amount or percentage which parties must not exceed, but it simply takes all relevant circumstances into consideration when it has to approve direct break fee agreements. Last year, it reduced a $1.5 billion break fee which Syngenta would have had to pay to ChemChina, to $848 million (1.99% of the transaction value). This is the largest break fee to date in Switzerland but still ranks at the bottom of the global market practice. It is striking to see that no break fee in a public deal exceeded the 2% level in recent years. Insofar, such limit has turned out a kind of psychological barrier although the Swiss Takeover Board would deny the existence of any limits. At the same time, such limit can also be useful to targets in negations of the size of (direct) break fees.

Data on reverse break fees is scarce, although they turn out to be a more common feature of deals. ChemChina, for example, would have had to pay a $3 billion reverse break fee (7% percent) if the deal did not go through.

Break fees can also be seen outside of classical takeovers by public offer. In contrast to public offers, other forms of a takeover, such as a statutory merger, are not subject to regulation by the Swiss Takeover Board. In Switzerland, a statutory merger without a prior public offer cannot be deployed as a takeover tool as easily as, e.g., in the United States. A main reason is that the merger consideration needs to (at least substantially) consist of shares of the surviving company, as the 90% threshold of all issued shares required for a squeeze-out merger typically cannot be achieved by a public company. However, a merger can be an appropriate mechanism if the shareholders of the target should receive shares or if the target is based outside of Switzerland. In particular, Swiss companies have used a triangular merger to merge with US companies, by which the US company was merged into a US subsidiary under applicable US state law and the Swiss company issued shares as part of the merger consideration. In such transactions, break fees have been recently agreed: In their 'merger of equals' announced 2017, each of (Swiss) Clariant and (American) Huntsman agreed to pay to the other party up to $210 million (2.1% of the transaction value) in the event of a change in recommendation for the merger or of the stockholders' failure to approve the merger. In 2015, (Swiss) ACE acquired (American) Chubb. Chubb agreed to pay to ACE a break-up fee of $930 million (3.29% of the transaction value) if the merger agreement would have been terminated because Chubb's change in recommendation for the merger or breach of the no-shop clause, while ACE was able to avoid a reverse break fee.

b) Challenges for board members

Involving Swiss bidding companies in international M&A transactions might expose their board members to challenges. As part of their strategic duties, Swiss board members must scout for business opportunities and present them to shareholders for a vote in the event of a merger or if the acquisition is equity financed.

Reverse break fees may be an essential element to create these opportunities for the general meeting to vote on. This is because the target company may not otherwise be willing to enter into the necessary transaction agreements, and only the board can negotiate a deal, even where shareholders' approval is required.

However, under Swiss law, where shareholders' approval is required, the board may not force shareholders into accepting a transaction by agreeing to a high reverse break fee. If it is a considerable amount, shareholders may feel compelled to approve a proposed deal only to avoid the payment of the agreed break fee.

In such a situation, the board may not agree to the fee unless it considers such a promise to be a necessity and a risk worth taking under the circumstances given the overall advantages of the envisaged transaction, with no better negotiations being possible. Furthermore, reverse break fees should not seriously interfere with a company's financial soundness, as this could be considered an *ultra vires* act. In other words, the board must feel confident that the agreed fee is in the company's best interest.

The board should carefully decide on this, i.e., following a diligent review process based upon adequate information and without conflicts of interest. Unlike for direct break fees, Swiss tender offer rules do not limit or apply to such reverse break fees. Therefore, they do not protect the board members. Obtaining external advice or a legal opinion from renowned experts can, however, help to increase their level of comfort.

c) Business judgment rule

Swiss corporate law gives the board considerable discretion in its business decision making. Since 2012, the Supreme Court has acknowledged the so-called business judgment rule as the standard for determining whether a board decision is within its discretion. If the business decision was made free of conflicts of interest and following a diligent review process based on adequate information, the business judgment rule provides that the merits of the board's decision can only be restrictedly reviewed by courts.

3) Trends

Another increase of the percentage values of reverse break fees is on the horizon. This also means that the average multiple of reverse Break Fee compared to direct break fees is growing. The increase will further challenge the decision-making in Swiss companies' boards. Consequently, the structure of reverse break fees will become more sophisticated. This can be achieved by negotiating different triggers and multi-tier fees with varying fee amounts. E.g., the bidder would agree to pay to the target a lower fee in case it fails to obtain its own stockholder or a recommendation change to its shareholders. If there is a failure to obtain required antitrust clearances or regulatory approval, the agreed reverse break fee could be significantly higher. And if a transaction fails to close due to the acquirers financing failure, the parties might agree on a medium-range fee. Another trend is to increase fees depending on the duration of the respective approval proceedings. Furthermore, parties more and more foresee reverse break fees as the exclusive indemnification where a transaction is terminated (so effectively providing for a walkaway option). Finally, in addition to direct break fees, the use of reverse break fees has recently gained and is going to increasing importance, particularly in strategic deals.

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Idorsia Ltd demerges from Actelion and lists on SIX Swiss Exchange

Reference: CapLaw-2017-47

On June 16, 2017, having completed its demerger from Actelion Ltd, Idorsia Ltd ("Idorsia") commenced trading on SIX Swiss Exchange. On its first day of trading, the shares of Idorsia Ltd opened at a price of CHF 10.00. Idorsia is an independent biopharmaceutical company specialized in the discovery, development and commercialization of small molecule therapeutics to meet significant unmet medical needs. It is based in Allschwil, Switzerland and has over 600 employees.

Landis+Gyr Initial Public Offering on SIX Swiss Exchange

Reference: CapLaw-2017-48

On 21 July 2017, Landis+Gyr Group AG ("Landis+Gyr") announced the pricing of its initial public offering on SIX Swiss Exchange at an offer price of CHF 78 per share, pricing at the top half of the offer price range. Trading of the Landis+Gyr shares on SIX Swiss Exchange commenced on the same day. With a total offer size of CHF 2.3 billion, the IPO of Landis+Gyr has been the largest IPO on SIX of the past ten years and thus far the second largest IPO in Europe of this year. Landis+Gyr is a leading global provider of smart metering and energy management solutions, operating one of the largest installed bases in the industry with over 300 million devices. Building on over 120 years of industry experience, Landis+Gyr has been at the forefront of the evolution of the global utility industry, enabling its transition from traditional towards "smart" grids.

Developments in Corporate Governance in accordance with the Swiss Corporate Law Reform Bill 2016 (Neuerungen im Bereich der Corporate Governance gemäss Vorlage zur Aktienrechtsrevision 2016)

Friday, 27 October 2017, CS Forum St. Peter, Zurich

http://www.eiz.uzh.ch/uploads/tx_seminars/Programm_VortragsreiheMittag__2017_09.pdf

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4. Convention on Compliance in the FinancialServices Industry (4. Tagung zur Compliance im Finanzdienstleistungsbereich)

Wednesday, 22 November 2017, Lake Side, Zurich

http://www.eiz.uzh.ch/uploads/tx_seminars/Programm_Compliance_22.11.2017_01.pdf

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Capital Markets and Transactions XIII (Kapitalmarkt – Recht und Transaktionen XIII)

Tuesday, 28 November 2017, Metropol, Zurich

http://www.eiz.uzh.ch/uploads/tx_seminars/Programm_Kapitalmarkt_28.11.2017.pdf