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Soft Sounding

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‘Soft sounding’ is the term used to describe the practice of issuers to discuss with handpicked investors certain terms of a contemplated capital market transaction prior to the public announcement of the transaction. This article discusses some of the Swiss law issues triggered by this practice.

By Patrick Schleiffer / Marcel Tranchet / Damian Fischer

1) Introduction

Often, and maybe even more so under the current difficult market conditions than it is normally the case, issuers wish to discuss with selected investors certain terms of a contemplated capital raising or refinancing transaction. The purpose of such discussions is to sound out the interest of such investors in the contemplated transaction. The practice is accordingly referred to as ‘soft sounding’ or ‘pre-sounding’.

Given that soft sounding takes place prior to the public announcement of the relevant transaction, there is a risk that non-public, price-sensitive and insider information is disclosed to third parties, *i.e.,* the investors. This triggers various questions under Swiss law. A common and important approach to mitigate the respective concerns is to enter into a confidentiality and standstill arrangement with the relevant investor. Such arrangement in turn raises the question whether a disclosure obligation under Swiss securities laws is triggered. Generally speaking, the issues discussed herein are not addressed explicitly in Swiss law and need to be analyzed by looking to general principles and to the untested views of practitioners.

2) Soft sounding and disclosure of price-sensitive facts and insider information

a) *Ad hoc*-publicity

Under the listing rules of SIX Swiss Exchange (SIX LR), an issuer must inform the market of any potentially price-sensitive facts arising in its sphere of activity and not known to the public. See article 72 SIX LR. Such information must be disclosed to the market as soon as the issuer has knowledge of the main elements of the relevant fact. However, the announcement can be postponed under certain circumstances, namely if the fact is based on a plan or decision of the issuer, a disclosure would have the potential to prejudice the valid interests of the issuer and provided that the issuer can ensure confidentiality of the relevant fact. If a leak occurs and confidentiality of the price-sensitive fact can no longer be upheld, the contemplated transaction must be announced to the public immediately in accordance with a leak contingency plan that the company must have prepared in advance.

The SIX LR further require that all market participants be granted the same access to price-sensitive information. It is therefore, as a rule, not permissible under the SIX LR to disclose price-sensitive facts to selected investors only. Still, the general view in Switzerland is that an issuer may disclose price-sensitive information to selected investors prior to the public announcement of a contemplated transaction if the respective disclosure is part of the decision making process of the issuer with respect to the contemplated transaction and if it is in the company's interest and if such investors enter into a confidentiality and standstill arrangement with the company and/or its advisors prior to the disclosure. Under such confidentiality and standstill arrangement, the investors must undertake to keep the received information confidential and to abstain from exploiting such information in any way whatsoever (in particular, undertake not to trade in the securities of the issuer) until the information is released to the public or until it otherwise loses its price-sensitive character. No specific form requirements are applicable to such confidentiality and standstill arrangements, but appropriate measures and precautions should be taken to document the arrangement.

b) Corporate law aspects

The duty of loyalty under Swiss corporate law requires the board of directors to observe the confidentiality of the company's matters. See article 717 (1) of the Code of Obligations (CO). Exceptions from such confidentiality duty are accepted if a disclosure is in the company's interest. An additional barrier arises from the obligation of the board of directors to treat the company's shareholders equally, if the investor to be approached is already a shareholder of the company. See article 717 (2) CO. Exceptions from this principle of equal treatment are accepted if a selective disclosure is in the company's interest, is justified by a valid reason, and if it does not result in undue preferential treatment of a particular group of shareholders.

Typically, soft sounding aims at reducing the abortion risks of a transaction and at reducing the risks of a pricing that is inconsistent with the then prevailing market conditions. That being said, the disclosure of confidential (and price-sensitive and insider) information to selected investors is in our view possible, provided that obtaining new funds is in the company's interest, that appropriate confidentiality and standstill arrangements are in place and, if the investors to be approached are already shareholders of the company, that there is no undue preferential treatment of such investors.

c) Insider trading

Article 161 of the Criminal Code makes it a criminal offence for, *inter alia,* members of the board of directors, management members, agents and advisors and certain other parties related to a company with securities listed in Switzerland, to obtain a monetary benefit for itself or a third party by (i) exploiting the knowledge of a non-public price-sensitive fact relating to such company or by (ii) bringing such price-sensitive information to the knowledge of a third party (so-called tippee). Note that under Swiss criminal law, a tippee also is subject to criminal sanctions if the received insider information is being exploited.

The prevailing view is that an insider (*e.g.,* a member of the management or an advisor) may disclose insider information to a third party (tippee) if reasonable steps are taken to protect the confidentiality of the information received and to prevent the tippee from exploiting such information in any way whatsoever (*e.g.,* by trading in the securities of the company) until the information is released to the public or until it otherwise loses its price-sensitive character.

d) Market abuse rules

In 2008, the Swiss Federal Banking Commission (now, since January 2009, the Swiss Financial Market Supervisory Authority FINMA) has enacted market conduct rules which are applicable to financial intermediaries (such as banks and securities dealers) subject to FINMA supervision. The relevant FINMA Circular 2008/38 provides guidance with respect to practices that the FINMA would consider market abuse, such as the misuse of price-sensitive information. See para. 7 et seq. of the FINMA Circular 2008/38.

Arguing that exploring a contemplated capital market transaction with investors constitutes a valid reason for the disclosure of price-sensitive information to selected investors prior to the respective public announcement, and, provided that appropriate confidentiality and standstill arrangements are in place preventing the investor from exploiting the information, the disclosure of such information by a bank (and its employees) in its capacity as financial advisor in the context of soft sounding should not in our view violate the FINMA market abuse rules.

e) Disclosure of price-sensitive information

If the soft sounding discussion requires the disclosure of price-sensitive information, the investor should (prior to the issuer's identity being revealed) be told that the information may be price-sensitive and insider information and that, by agreeing to receive the information, the investor is agreeing to keep such information confidential and that the investor will abstain from trading in securities in the company and from otherwise making any use of such information. If the investor does not agree to such confidentiality and standstill undertaking, the conversation should not be commenced and no further explanation should be given.

Conversely, it is our view that the *ad hoc*-publicity and insider trading rules are not applicable if the company (through its advisors) discusses the potential transaction with investors on a no-names basis (possibly, with reference to an industry sector or the like). Care must be taken though in such scenario that the disclosed information is sufficiently generic so as not to allow the investors to identify the relevant issuer. That being said, disclosing information on a no-names basis may be subject to practical obstacles, in that the investor may not be willing to discuss a transaction on a no-names basis or in that the disclosed information will allow the investor to identify the relevant issuer.

f) Termination of confidentiality and standstill arrangement

Information will no longer constitute price-sensitive and insider information, once a public announcement of the contemplated transaction is made in accordance with the *ad hoc*-publicity rules of SIX LR. Accordingly, at that point, the restrictions will fall away and the confidentiality and standstill undertakings can terminate in accordance with the respective terms of the relevant arrangement.

The situation is less clear where a contemplated transaction is not being pursued and no issuer announcement is made to cleanse the market. In such scenario, the relevant investors should be informed in due course about the fact that the transaction is not being pursued further and that the relevant confidentiality and standstill arrangement is or will terminate in accordance with its terms. However, no further explanation should be given by the company and its advisors as it may itself amount to price-sensitive information and trigger the need for an additional confidentiality and standstill obligation of the investor. If a transaction is postponed only as opposed to not being pursued further, the relevant confidentiality and standstill obligations will, in our view, have to continue to apply.

3) Soft sounding and disclosure of shareholdings in listed companies

Pursuant to the current practice of the Disclosure Office of SIX Swiss Exchange, shareholders entering into lock-up agreements with the issuer and/or the underwriters in the context of a capital market transaction are deemed to be an organised group acting in concert which triggers an obligation to disclose such group and their shareholdings pursuant to article 20 (3) of the Swiss Stock Exchange and Securities Trading Act, provided that a relevant threshold is reached or exceeded. The reasoning for this is that the entering into of lock-up agreements constitutes so-called parallel behaviour of the relevant shareholders which, pursuant to the Disclosure Office of SIX Swiss Exchange, is regarded as acting in concert.

The legal question in the context of soft sounding is therefore whether the entering into of (individual) confidentiality and standstill arrangements has to be viewed as a group for disclosure purposes, if such investors are, at that point, already shareholders of the issuer, and their shareholdings in such issuer, on a consolidated basis, would trigger a disclosure obligation.

In the context of an IPO, the shareholders being subject to a lock-up undertaking are typically known to each other and the entering into of a lock-up can be considered as a pre-condition for conducting an IPO and therefore is typically in the common interest of such shareholders. Conversely, in the context of soft sounding, the investors are typically approached on an individual basis without the identity of any other approached investors being revealed to them. Also, the investors normally share no common interest (except that they may be interested in participating in the proposed transaction). Therefore, investors which have to enter into confidentiality and standstill arrangements in order to discuss the proposed transaction do not, in our view but again in the absence of published precedents, form a group for securities disclosure purposes.

The position will be different however if an investor, following the soft sounding discussions, enters into a binding commitment with the company and/or its financial advisors pursuant to which the investor undertakes, subject to certain conditions, to participate in the transaction. Such binding commitment would have to be disclosed, provided a relevant disclosure threshold is reached or exceeded.

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New Investors' Right in Public Takeover Offer Proceedings

Reference: CapLaw-2009-15

On 1 January 2009, the revised Swiss public takeover regime came into force. The revision includes a new right for shareholders with shareholdings of at least 2% to participate in takeover proceedings. The implication for bidding entities is substantial, and may frustrate the ability of bidders to predict the commencement of the offer period and to estimate the duration of the takeover offer as a whole.

By Mariel Hoch Classen

1) Legal framework

Qualified shareholders may request to become formal parties to the takeover proceedings according to article 33b (3) of the Securities and Stock Exchange Act (SESTA) and article 56 (3) of the Ordinance on Public Takeover Offers of the Takeover Board (TOO), and will in principle have access to all documents filed with the TOB. Under the former regime only the bidder (and persons acting in concert with the bidder), the target company (and a competing bidder, if any), were parties to the takeover proceeding. However, shareholders holding at least 5% in the target company had certain limited rights to be heard (so called intervention) but did not have access to filed documents.

a) Types of proceedings

A qualified shareholder may become a party to two types of proceedings: (i) the proceedings regarding the ***review of a public takeover offer*** (articles 59 and 60 TOO) and (ii) the proceedings regarding an ***exemption from the obligation to make a public takeover offer*** (article 61 TOO). Depending on the circumstances in each of the two proceedings, a qualified shareholder may become a party either (i) by way of filing an ***application*** or (ii) by lodging an ***objection*** with the TOB. The following sections will focus on public takeover offer proceedings, since most of the challenges in relation to qualified shareholders as parties are expected to occur via this type of proceeding.

b) Qualifying shareholding

As per the revision of the takeover regime on 1 January 2009 the right to become a party to the proceedings has been granted to a shareholder holding at least 2 per cent of the voting rights of the target company, irrespective of whether the voting rights are exercisable (so called qualified shareholder). The wording of the applicable provisions suggests that the threshold must be met by each shareholder requesting to become a party individually. It may, however, not be excluded, that the TOB will take a different view on this question and hold that several shareholders, acting in concert, may reach the threshold jointly.

The minimum 2 per cent shareholding must be held from (i) the date of the ***publication of the pre-announcement*** or the ***prospectus*** (if no pre-announcement is made) in proceedings regarding the review of a takeover offer and (ii) from the date of ***publication of the board report*** in proceedings regarding an exemption from the offer obligation. A shareholder loses its right as a party once its shareholdings are reduced below 2 per cent.

A qualified shareholder must provide the TOB with evidence of its qualifying minimum shareholding as of the triggering date as part of its request to participate in the proceedings. In addition, a qualified shareholder must provide evidence of the continuous maintenance of a qualifying stake upon the TOB's demand. Such a demand by the TOB may occur at any time during the proceedings. The qualified shareholder is, however, not obliged to disclose his exact shareholding. In order to monitor and determine the size of a significant stake build-up by a qualified shareholder, interested persons (including the bidder and the target company), will have to rely upon (i) the trade notifications that each party to the proceedings must file with the TOB on a daily basis during the proceedings (articles 38 *et seqq.* TOO) and (ii) mandatory shareholder notifications that are triggered by the 3, 5, 10, 15, 20, 25 331/3, 50 and 662/3 per cent thresholds (article 20 SESTA).

c) Application

A qualified shareholder may participate in takeover proceedings as a party by filing an application (*Antrag, requête;* article 57 TOO) with the TOB. The confirmation or rejection of the party status by the TOB is expected to be dealt with in a decision *(Verfügung; décision)* of the TOB in order to allow any party to the proceedings or the rejected shareholder to effectively challenge it.

The written application must include evidence documenting the required 2 per cent minimum shareholding. It must be filed with the TOB within ***five trading days*** from the publication of (i) (a) the offer prospectus or (b) the first decision of the TOB regarding the offer, if such decision is published prior to the prospectus, in proceedings regarding the review of a public takeover offer or (ii) from the publication of the board report in proceedings regarding an exemption from the offer obligation.

As regards takeover offer proceedings it is not entirely clear whether the TOB allows applications and accepts the resulting party status of qualified shareholders during the period between a pre-announcement of an offer and the events which trigger the five trading days application period (*i.e.* the publication of the offer prospectus or the first decision, if it is published prior to the prospectus; see TOB decision of 26 February 2009 regarding Harwanne Compagnie de participations industrielles et financières SA).

Following the approval of an application, the qualified shareholder will, in principle, be heard as a party prior to any subsequent decision by the TOB in relation to the offer. It is assumed (but not entirely certain) that the party status will be extended to any competing offer. To rule out any uncertainty the qualified shareholder may secure its participation by filing an additional application once a competing offer has been published.

d) Objection

A qualified shareholder may avail itself of a second instrument in order to join proceedings as a party. The objection (*Einsprache, opposition;* article 58 TOO) may be used for this purpose, the aim of which is to cause a ***re-evaluation of a decision*** by the TOB. The basis of the objection is that the TOB issued its decision in the absence of the qualified shareholder's views. This may be (i) due to the fact that the first decision in relation to the offer is published prior to or concurrently with the offer prospectus, or (ii) because the qualified shareholder could not be heard in a timely manner prior to a decision.

If a qualified shareholder does not wish to object to a first decision, but nevertheless intends to secure its party status, or if the offer prospectus is published prior to a first decision on the offer, the qualified shareholder must seek its party status by way of application.

An objection must include a request for alteration of the TOB's first decision, a summary of the rationale, and evidence supporting a qualifying shareholding. The objection must be filed with the TOB within ***five trading days*** from (i) publication of the TOB's first decision on the offer, if such decision is published prior to, or concurrently with, the offer prospectus in proceedings in relation to the review of a takeover offer, (ii) the board report in relation to decisions regarding an exemption from the offer obligation, and (iii) any decision of the TOB prior to which a qualified shareholder with a party status, which was previously and in due time acquired, could not be heard.

If the objection is received, the ***TOB will issue a second decision*** which will deal with the qualified shareholder's request. This second decision may be challenged before the Swiss Financial Markets Supervisory Authority (FINMA), and subsequently, before the Federal Administrative Court. The ***offer period may not commence*** until the TOB has issued its second decision and until the FINMA has decided. In the event that the Federal Administrative Court suspends the coming into effect of the FINMA's decision, the offer period may only begin once the court's decision is final and binding. Therefore, a qualified shareholder may cause ***significant delays of the takeover offer*** should it decide to effectively make use of its party rights.

e) Bidder's withdrawal right

The TOO does not define the first possible date of publication of the ***first decision on the offer*** of the TOB. There is reason to assume that no decision on the offer will be published prior to a pre-announcement. Should this nevertheless occur, such decision may not be deemed a first decision on the offer under the relevant provisions and therefore such a decision would not trigger the beginning of the five trading day application or objection period. The main reason that leads to this conclusion is that the 2 per cent threshold must not be met by a qualified shareholder any time prior to the date of the pre-announcement.

The new shareholder right discussed here creates uncertainty for a bidder who aims to obtain a binding decision from the TOB, on any aspects related to an envisaged offer (such as compliance with the price rules or permissibility of conditions), prior to the publication of the pre-announcement. It is likely that the TOB will continue to issue decisions before a pre-announcement and suspend their publication until the date of the pre-announcement. Should the TOB subsequently revise its first decision based on a shareholder's objection (or the FINMA reverse it), then the bidder must be allowed to ***withdraw from its pre-announced offer.*** Although this has not been tested yet, an explicit way for the bidder to secure its way out would be to include a respective condition in the offer documents. As the clearance obtained in the first decision was a prerequisite condition to the bidder's launch of the offer a subsequent reversal of the decision must consequently allow it to withdraw from or adapt its offer accordingly.

f) Forfeiture of right to become a party

A shareholder must file an application or an objection within the five trading days period in order to secure its participation in the subsequent stages of the proceedings, since the TOO clearly defines which events trigger the period during which party status may be acquired.

Therefore, a qualified shareholder must file an application to ***prevent the forfeiture*** of its procedural rights in regard to any subsequent decisions, even when the qualified shareholder does not intend to challenge the TOB's first decision on the offer. This attribute of the revision causes uncertainty for bidders who wish to assess the intent of qualified shareholders who file applications for party status. It will be unclear to the bidder whether an applicant aims to challenge the published offer documents, or simply gain rights as a preventive measure.

2) Expected Impact

It is likely that potential bidders will adapt to the new risks of takeover offer challenges by qualified shareholders by selecting simplified offer structures. Creative and unusual structures are less likely to be employed due to the additional risk of a delay of the offer and possibly also higher financing costs (*e.g.* later long stop dates) that such offer structures may now imply.

The new shareholders' right discussed here may therefore, to a greater or lesser extent, negatively affect the competitiveness of the public takeover market. It is expected, however, that bidders who successfully avoid qualified shareholder offer challenges reduce the risk of competing offers being launched.

For potential competing bidders, the possession of a qualifying stake in the target company at the triggering date, now provides advantageous procedural rights. As a party to the proceedings related to the first offer, the potential bidder will gain insights and time to prepare a superior offer.

A qualified shareholder may as well simply use its right to collect information contained in the offer file held by the TOB. The information requested by a challenging shareholder regarding, for example, the accuracy of the board report of the target company, or the appropriateness of a fairness opinion, may be particularly valuable should a shareholder aim to challenge certain aspects of a transaction subsequent to the takeover offer. Such challenged aspects could include the adequacy of compensation or the exchange ratio in a squeeze-out proceeding or in another merger scenario.

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Takeover Board Clarifies Permissible Offer Consideration in Voluntary Bids

Reference: CapLaw-2009-16

An ambiguity in the recent overhaul of the Swiss takeover regime has sparked a debate as to whether share only exchange offers are still permissible in voluntary offers under the revised regime. The TOB has now clarified that the mandatory cash alternative only applies to pure mandatory takeover offers. Voluntary offers can continue to be made by way of a share exchange, provided, the offeror does not purchase any shares against cash after announcement of the offer.

By Thomas Reutter

Effective as of 1 January 2009, article 43 (2) of the FINMA Stock Exchange Ordinance (SESTO-FINMA) has been changed to state that a share exchange offer is permissible in case there is an alternative cash consideration offered. Since the provisions of SESTO-FINMA govern not only mandatory takeover offers but also (mandatory) pricing provisions for certain voluntary offers, the scope of this new provision remained unclear. The Takeover Board (TOB), by promulgating communication no. 4 (Mitteilung Nr. 4; communication No 4), has now clarified that article 43 (2) SESTO-FINMA is only applicable in case of mandatory offers in the sense of article 32 of the Stock Exchange Act.

Thus, in the absence of a special provision in the articles of incorporation of the target, an acquirer of shares must generally only make an alternative cash offer if it has acquired (and settled) a stake exceeding the threshold of 33⅓% of the shares issued before launching a takeover offer. In communication no. 4, the TOB promulgated one exception to the above rule, which, however, seems difficult to reconcile with the current wording of the law. The TOB takes the view that an offeror may no longer offer an exclusive share consideration in any takeover offer in case it acquires shares against cash after the announcement of the offer, *i.e.* during the applicability of the so-called 'best price rule'. The TOB justifies these restrictions by considerations of equal treatment.

In a 'Frequently Asked Questions' section of communication no. 4 the TOB discussed and clarified the following issues:

– A voluntary offer may be made subject to an exclusive share consideration even if the shares are illiquid. If such is the case, the review body of the offer must provide a valuation of the shares offered as consideration.

– Following consummation of a voluntary share exchange offer no subsequent (mandatory) offer must be made to the remaining free float shareholders if as a result of the voluntary share exchange offer the threshold of 33⅓% is exceeded.

– In case the offeror acquires shares against cash post announcement of a share exchange offer, a cash consideration alternative must be extended to all recipients of the offer and the pending offer must be changed accordingly. Shareholders who have accepted the share only offer may not withdraw their acceptance, but are allowed to opt for the cash consideration in the changed offer.

While clarifying important ambiguities, communication no. 4 also raises new ones. For example, it remains unclear whether the purchase of a stake against cash that is entered into prior to any announcement of a takeover offer but closed after such announcement pre-empts the offeror from making a share only offer. In addition, it remains uncertain how offers with a share and a cash component are being treated. It may not be excluded that these offers are subject to the rules of pure share exchange offers.

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TOB Order: The Impact of a Shareholders' Agreement Among Private Equity Investors on the Obligation to Make a Public Offer

Reference: CapLaw-2009-17

On 10 February 2009, the Swiss Takeover Board (TOB) issued an order regarding Esmertec AG (Esmertec) and its four major shareholders, together holding 43%. The TOB found that they were not acting in concert in connection with Esmertec's acquisition (share exchange) of Purple Labs, even though these four shareholders held 95% in Purple Labs and were bound by a characteristic private equity shareholders' agreement. However, the order does not result in clear law regarding the qualification of shareholders' agreements under the acting in concert rules.

By Severin Roelli

1) Facts

Esmertec, a Swiss stock corporation, has its shares listed on the main segment of the SIX Swiss Exchange. It is contemplating a potential proposal to its shareholders to acquire Purple Labs, a French company, by means of a share exchange, whereby the exchange shares would be created by way of a capital increase of an amount equal to Esmertec's existing capital. This would require the shareholders' approval of the capital increase together with a waiver of their pre-emptive rights (Transaction). The newly created shares would be paid up in kind (Purple Labs shares).

Both Esmertec and Purple Labs have the same major shareholders: Sagem Télécommunication SA (Sagem) with 7.34% and 6.19% of the voting rights of Esmertec and Purple

Labs respectively as well as three private equity funds managed by (i) Partners Group Holding AG (Partners Group) with 9.93% and 16.95%, (ii) Earlybird Verwaltung GmbH (Earlybird) with 6.69% and 24.55%, and (iii) Sofinnova Partners SAS (Sofinnova) with 19.24% and 47.51% of the voting rights of Esmertec and Purple Labs respectively.

Partners Group and Sofinnova on the one hand and Earlybird and Sofinnova on the other hand, each have one representative on the board of Esmertec and Purple Labs respectively.

Pursuant to a shareholders' agreement between the four major shareholders of Purple Labs, the board of Purple Labs must have a majority of independent directors and, in addition to pre-emptive and *tag along* rights, the parties to the agreement undertake to sell their holding in Purple Labs if 60% of the shares of Purple Labs are sold *(drag along right).* The agreement does not contain any further rules concerning the exercise of voting rights at shareholders' meetings.

Against this background the TOB had to decide whether the Transaction would trigger a duty of the major shareholders to make a public offer for Esmertec pursuant to article 32 (1) of the Stock Exchange Act (SESTA).

2) Considerations of the TOB

Given that none of the major shareholders would individually exceed the mandatory offer threshold of 33⅓% of the voting rights of Esmertec at any time before or after the Transaction, the TOB's considerations focused on the question of whether the major shareholders effectively acted in concert, or whether their decision to agree to or to execute the Transaction would constitute acting in concert to control Esmertec for the purposes of article 31 in connection with article 10 of the FINMA Stock Exchange Ordinance (FINMA SESTO).

In determining whether there was a case of acting in concert, and applying the practice developed by the TOB, the Federal Banking Commission (the supervisory authority of the TOB before the change of the law on January 1, 2009) and the Supreme Court, the TOB, in the absence of a written agreement between the major shareholders of Esmertec in relation to their Esmertec participations, considered the indications in favor of and against a coordinated exercise of the major shareholders' voting rights in Esmertec.

First, the TOB held that the major shareholders' participation in the two companies, together with the existence of a shareholders' agreement relating to Purple Labs, could suggest the existence of an implied agreement between them to coordinate the exercise of their voting rights within Esmertec. The TOB then considered the shareholders' agreement and held that:

- the undertaking of the major shareholders to have a majority of independent directors together with their rights of exit (tag along and drag along rights) were aimed at permitting a coordinated disinvestment and thereby increasing the value of their investments rather than binding the shareholders to a corporate strategy;
- the shareholders' agreement did not regulate the exercise of voting rights at shareholders' meetings of Purple Labs and certainly did not regulate the exercise of voting rights at shareholders' meetings of Esmertec; and
- a forced seller under the drag along clause of the shareholders' agreement had no contractual obligation to approve the Transaction by voting for it at the Esmertec shareholders' meeting.

Accordingly, the TOB found that the existence of the shareholders' agreement in respect of Purple Labs could not be used as an indication for the existence of acting in concert regarding Esmertec.

Further, the TOB held that the idea of an understanding between Esmertec and Purple Labs originated from a time when the major shareholders of Esmertec had not yet become shareholders of Purple Labs and that those plans were later abandoned. It found that despite the involvement of the same investors in both companies, no agreement could be reached, possibly because their interests and their behavior did not converge in a way that would constitute acting in concert to control Esmertec.

However, as potential acting in concert in the future could not be ruled out, it was necessary for the TOB to assess the situation in view of the existing circumstances and the steps necessary to realize the Transaction, which required, in particular, Esmertec's shareholders' approval in respect of an increase of its capital.

In light of the above and given that Sofinnova, Partners Group and Earlybird were private equity investors aiming to revaluate their investments by selling on their participations in the medium term, the TOB concluded that the indications in favor of their acting in concert were relatively weak and insufficient. The single fact that the major shareholders would vote in favor of an increase of Esmertec's capital would not in itself constitute acting in concert and, therefore, would not, in the TOB's view, be sufficient to impose a duty to make a public offer under article 32 SESTA.

3) No General Rule on Acting in Concert under Shareholders' Agreements

In summary, the TOB held that a shareholders' agreement which:

- provides for a majority of independent directors;

– does not provide for rules on how to exercise voting rights; and

– does not bind the shareholders to a corporate strategy

cannot be taken as evidence for acting in concert of the parties to the shareholders' agreement.

This is in line with the majority of legal commentators who are of the opinion that shareholders' agreements limiting only the right of disposal of the shareholders do not confer control over the company. Hence, they do in no event trigger the duty to make a public offer.

However, shareholders, who individually do not own more than 33⅓% providing for a drag-along in their shareholders' agreement, will have to take the argument seriously that they act in concert, if their drag-along covers more than 33⅓% of the company and, thus enables them to effectively control the company (by reason of the fact that they are able to procure control over the company).

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Hybrid Financial Instruments—Revisited in Light of the Financial Market Crisis

Reference: CapLaw-2009-18

Hybrid financial instruments that combine elements of debt and equity instruments have become increasingly popular with banks and insurance companies for meeting regulatory capital requirements. However, their usage in connection with bank bailouts and emergency funding transactions has raised concerns as to their suitability to stabilize financial services companies and as to the features that they should have or not have.

By René Bösch

Hybrid financial instruments are instruments issued by banks or insurance companies which combine debt and equity features, in particular subordination, deferral or cancellation of interest payments, perpetuity, etc. In recent years hybrid instruments have been increasingly used by credit institutions to increase their regulatory capital.

Following an initiative launched by the European Commission in June 2005 for the adoption of a harmonized regulatory framework applicable to hybrid capital instruments, the Committee of European Banking Supervisors (CEBS) issued a draft proposal (CEBS-Proposal) in December 2007 setting out the key features for a uniform definition of hybrid instruments. The probably most vividly debated element of the

CEBS-Proposal related to the proposed requirement that hybrid instruments do need to provide for ***loss absorption*** in the form of a (temporary) write-down of the principal of the instruments in times of financial distress, or the conversion into common equity. Moreover, the CEBS-Proposal intended to limit the application of the alternative coupon settlement mechanisms (ACSM) for tax reasons where the issuer had full discretion on the decision whether or not to pay dividends. Following widespread criticism from the financial industry, the CEBS-Proposal was amended in March 2008 to reflect the feedback received. The new consultation paper removed the absolute requirement for the write-down or the conversion into common equity and focused instead on the possibility of a recapitalization or the prevention of outflow of moneys to the investors in times of financial distress.

The financial crisis also led to further reviews of the usage of hybrid instruments and in particular their features. Generally hybrid instruments and in particular the Tier 1 instruments have become subject to scrutiny in light of various developments:

– Hybrid capital supplied by governments in bank bailouts has usually been classified as Tier 1, but often lacked the features intended and prescribed by the 1988 Basel Rules, as supplemented by the Sydney press release, released by the Basel Committee on Banking Supervision on 27 October 1998 (BIS Press Release). The definition of capital components set out in the original Basel capital accord as well as the BIS Press Release have not been amended since by the Bank for International Settlements or the Basel Committee and still underlie the Basel II framework. However, developments in national and international capital markets have demonstrated a widening diversion of qualifying or disqualifying elements for hybrid financial instruments.

– Investors have become increasingly concerned in bank bailouts as to their position within the different tiers of capitals. In several instances preference shares have been issued to the government that were intended to be preferred over the instruments of third party investors, both in terms of repayment as well as interest payments. These concerns have been particularly expressed in relation to potential nationalizations of banks.

– More and more the view emerged and now seems to prevail that preference stock issued to national governments is not a substitute for common equity as it does not boost the long term capacity of a bank to absorb losses without defaulting.

The recent bank bailouts or support programs for banks in various jurisdictions have demonstrated that currently there is a lack of a uniform approach to and a lack of agreement in respect of the common definitions and characteristics that core Tier 1 instruments do need to fulfill. On the other hand, a widening disparity has arisen in various jurisdictions as to the true meaning and contents of the term 'Hybrid Tier 1

Instruments'. Moreover, investors have suddenly realized that some of the financial instruments they are holding do bear some significant risks and are not equivalent to a mere bond; in particular, the holders of some Tier 1 hybrid instruments issued by Deutsche Bank where shunned in December 2008 when Deutsche Bank decided not to call the instruments upon the occurrence of the first call day.

A study published by Merrill Lynch in November 2008 added to some further debate by taking up the already known distinction between core and non-core Tier 1 capital and adding a new, additional layer of complexity, distinguishing now between regulators' and equity investors' views. Pursuant to this study, an instrument may constitute core Tier 1 capital for regulators, but not so for equity investors. In making this distinction, Merrill Lynch focused in particular on the issue how the instruments do bear losses.

All of these trends led to a wide range of regulatory approaches in different countries, approaches that were often geared towards and determined by the actual needs in particular bank bailouts. The downside of all of this is an emerging trend to particular national regulation rather than international harmonization. As a result the market lacks a uniform and common understanding as to what core or non-core Tier 1 instruments are and what their common features shall be.

The Swiss regulator so far has still adhered to the basic Basel I Rules of 1988 and the guidance provided by the BIS Press Release. However, in recent years the Swiss regulator has also started to distinguish between core and non-core Tier 1 capital in relation to financial instruments. On the other hand, the Swiss regulator has determined that deeply subordinated, perpetual bonds can qualify as Hybrid Tier 1 capital if these instruments basically fulfill the requirements set out in the BIS Press Release. Just recently the Swiss regulator has now allowed the two big banks UBS and Credit Suisse to distinguish 3 categories of non-core hybrid instruments in order for them to be still attributed to Tier 1 capital; however, the total of all such non-core Tier 1 instruments is limited to 50%.

– A maximum of 15% of Tier 1 capital can be in the form of 'innovative instruments' that either have a fixed maturity or an incentive to repay such as a step-up in the coupon if the instrument is not redeemed when callable.

– A maximum of 35% of Tier 1 capital less the instruments subject to the 15% limit can be in the form of hybrid capital instruments that have no fixed maturity and no incentive for repayment.

– A maximum of 50% of Tier 1 capital less the instruments subject to the 15% and 35% limit can be in the form of instruments that include a predefined mechanism that converts them into core capital such as mandatory convertible bonds convertible into common stock.

With respect to mandatory convertible bonds, however, it is noteworthy that they still can be structured in such a way that upon their issuance good Tier 1 treatment for company law and regulatory purposes can be achieved.

It is without doubt that the experience with the recent bank bailouts and potentially further bailouts yet to come calls for the regulators to harmonize their views as to the common characteristics that such instruments must fulfill in order to be eligible to account for core or non-core regulatory capital. For so long as such common understanding is lacking there exist competitive disadvantages in certain jurisdictions where regulators still adhere strictly to the requirements imposed by the original BIS Rules as well as the BIS Press Release.

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Switzerland Facilitates the Approval Process for the Public Distribution of Foreign Collective Investment Schemes in or from Switzerland

Reference: CapLaw-2009-19

The Swiss Federal Council and the Swiss Financial Market Supervisory Authority (FINMA) decided in January 2009 that certain material and formal requirements in relation to the approval of foreign collective investment schemes for public distribution in or from Switzerland (called the ***'Swiss Finish'***) will be relaxed with effect from 1 March 2009. Accordingly, the new Swiss standards will certainly be welcomed by providers of foreign collective investment schemes seeking to access the Swiss market. The importance of Switzerland as a major market for collective investment schemes will be further enhanced.

By Marco Häusermann

1) The 'Swiss Finish': Overview

The set of formal and material rules referred to as the 'Swiss Finish' are stricter than the corresponding rules under the EU Undertakings for Collective Investment in Transferable Securities (UCITS) III directives. This includes:

– ***naming of the collective investment scheme:*** at least ***two thirds*** of the investments of a collective investment scheme must be compliant with the name of the collective investment scheme to the extent that such a name indicates a certain investment strategy (*e.g.* if the name of an investment fund is German Equity Fund, at least two thirds of its investments must be in German equity);

- ***management fees for investments in related target funds (no double dip):*** if a foreign collective investment scheme invests in related target funds, the licensed market participants are not allowed to levy any issuance and redemption commissions and shall levy only a ***reduced management fee*** (according to the current practice of the FINMA, generally ***no more than 0.25%***). A target fund is considered as related if, for example, the target fund is managed by a company to which the management company of the foreign collective investment scheme is related by virtue of a direct or indirect interest of ***more than 10% of the capital or the votes;***

- ***information and transparency rules*** require specific information (or risk warnings) for Swiss investors regarding:

  - the maximum leverage ratios permitted by the foreign collective investment scheme;

  - the possible negative consequences of a currency hedging for different unit classes;

  - the principle that sub-funds of a foreign umbrella fund are considered separate collective investment schemes and, therefore, are liable solely for their own liabilities (or for the provision of a disclosure warning if this is not the case);

  - Swiss-related aspects in relation to a foreign collective investment scheme such as the name of its representative in Switzerland, the place where the scheme documents can be obtained and the form and date of publications in Switzerland;

  - the payment of reimbursements *(Rückvergütungen)* and trailer fees *(Bestandespflegekommissionen)* by the foreign collective investment scheme to third parties (in line with the Swiss Funds Association's 'Guidelines on transparency with regard to management fees' dated 7 June 2005).

2) The 'Swiss Finish': New Standards

The relaxing of the 'Swiss Finish' was originally initiated when the FINMA definitively renounced to regulate the performance fee with effect from 1 April 2008. As of 1 March 2009, the following new standards will apply to the 'Swiss Finish' rules:

a) Name of the Foreign Collective Investment Scheme

The FINMA will no longer impose quantitative (two thirds) investment requirements but will shift the responsibility to the licensed market participants to ensure that the name of a foreign collective investment scheme does not confuse or deceive investors. The

FINMA requires that ***licensed market participants inform investors in a clear and comprehensive way on the investment policy in the offering materials.*** The FINMA reserves the right to intervene in the case of a deceptive naming. Only in obvious and severe cases may the FINMA intervene while the approval process is ongoing.

b) Management Fees/No Double Dip

In accordance with existing Swiss law and the rules of the UCITS III directives, levying ***issuance and redemption commissions*** remains prohibited if investments are made in related target funds.

Regarding the ***management fee,*** the definition of a related target fund under the Collective Investment Schemes Ordinance will be amended to the extent that the 10% capital and voting right threshold in a common management company is being replaced by a *'**substantial** indirect or direct investment'* test. The meaning of a 'substantial' investment though remains unclear, however, EU practice seems to indicate that the threshold is closer to 30% than to 10%. Further guidance from the FINMA would be desirable.

In addition, the FINMA will no longer impose a quantitative maximum amount (*i.e.* 0.25%) of ***management fee*** but leave it to the licensed market participants ***to transparently and comprehensively disclose the maximum level of management fees*** charged at the level of the collective investment scheme itself and at the level of the related target fund in the scheme documentation in the offering materials. In their annual reports, licensed market participants must disclose the proportions of the management fee borne by the collective investment scheme and the related target fund in which it invests.

The FINMA may also extend the above concepts to investments other than in target funds.

c) Information and Transparency Rules

i. Leverage and Currency Hedging Warning

The handling of leveraging and currency hedging for unit classes under the current Swiss collective investment schemes law is, other than under the old Investment Fund Act, equivalent to the regulations under the UCITS III directives. The warnings about risk and costs associated with leveraging and hedging will therefore no longer be required.

ii. Liability between Sub-funds

As the UCITS III directives do not predefine a liability concept between sub-funds of an umbrella fund but leave the answer to the member states' own regulations, the FINMA has come to the conclusion that a specific disclosure or risk warning (if sub-funds would be liable for liabilities of other sub-funds) for investors in Switzerland is no longer necessary as this issue will anyway be dealt with in the offering materials of the foreign collective investment scheme.

d) Special Annex to the Prospectus of Foreign Collective Investment Schemes for Swiss Investors

The Swiss Funds Association in cooperation with the FINMA prepared a template for an annex to the prospectus of a foreign collective investment scheme to be publicly distributed in or from Switzerland. The annex specifies certain information on the foreign collective investment scheme that must be separately disclosed to investors in Switzerland, in particular information regarding (i) the representative and paying agent in Switzerland, (ii) the place from which the offering materials and other related information can be ordered, (iii) the place and date of publications in Switzerland, (iv) the payment of reimbursements *(Rückvergütungen)* and trailer fees *(Bestandespflegekommissionen)* and (v) the place of performance and the applicable jurisdiction.

The annex must be provided to investors in Switzerland together with the other offering materials.

3) Impacts of the New Standards

The new standards are relevant for ***Swiss collective investment schemes*** as regards the naming (no longer a two thirds' rule) and the double-dip rule.

For ***UCITS III compatible*** foreign collective investment schemes the changes apply to the extent that these collective investment schemes will be publicly distributed in or from Switzerland.

As regards ***non-UCITS III compatible*** foreign collective investment schemes that will be publicly distributed in or from Switzerland, the FINMA will continue to conduct a full review and analysis of the schemes. Approval will be granted if, inter alia, a collective investment scheme enjoys an equivalent level of supervision in its home country in a way that is intended to protect investors and if the organization, the investor rights and investment policy of the fund management company or the investment scheme company are equivalent to Swiss law. If the FINMA concludes that the foreign collective investment scheme is subject to rules equivalent to these Swiss standards, the benefits of the new Swiss standards will also apply to non-UCITS III compatible foreign collective investment schemes.

4) Outlook

On 13 January 2009, the European Parliament voted in favor of the proposed reform of the UCITS III directives. It is expected, subject to the approval of the new UCITS IV directive by the European Council, that these rules will be implemented by the various EU member states by no later than 1 July 2011. The UCITS IV directive includes proposals for a short and harmonized 'Key Investor Information' document, a simplified notification procedure to facilitate cross-border distribution of UCITS, a new framework for (cross-border) mergers of UCITS and permission of 'master-feeder' structures, the strengthening of co-operation between national regulators and management company passporting.

These changes of EU laws and regulations will require ongoing monitoring and further adjustments to Swiss laws and regulations will be necessary in the future to ensure a continuing smooth approval process for UCITS compliant collective investment schemes in Switzerland on the one hand and Swiss collective investment schemes in the EU on the other hand.

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FATF's Recommendations Implemented

Reference: CapLaw-2009-20

The amended recommendations of the Financial Action Task Force (FATF) have been implemented in the Swiss legislative process as of 1 February 2009. This change entailed additional predicate offences for money laundering and financing of terrorism, introduced new duties for financial intermediaries and also improved the financial intermediaries' situations in cases where they notify the Money Laundering Reporting Office Switzerland (MROS) of the suspected money laundering or financing of terrorism.

By Benjamin Leisinger

1) Background

Based on the 40+9 recommendations of the Financial Action Task Force (FATF), an inter-governmental body whose purpose is the development and promotion of national and international policies to combat money laundering and terrorist financing (see *http://www.fatf-gafi.org*), Switzerland improved its legislation in order to effectively fight money laundering and the financing of terrorism.

As per 1 February 2009, some of these legislative changes entered into effect.

2) Specific Changes Relevant for the Financial Sector

Based on the Law regarding the Implementation of the Revised Recommendations of the Financial Action Task Force of 3 October 2008, several Swiss legislative acts are revised as of 1 February 2009.

a) Notification only to the Money Laundering Reporting Office Switzerland

One change concerns article 305^{ter} (2) of the Swiss Penal Code (PC) and its justification to pass certain data on to the authorities. Article 305^{ter} PC states that whosoever professionally accepts, takes into custody, invests or helps to transfer assets belonging to a third party (so-called financial intermediaries, see decision of the Federal Supreme Court 129 IV 329, p. 331), and fails to identify the beneficial owner with the diligence required under the circumstances, shall be punished with imprisonment of up to one year or a fine (up to CHF 1.08 million). Article 305ter's second paragraph provided for the financial intermediaries' entitlement to notify the Swiss penal prosecution authorities and the federal authorities designated by law of any indications leading to the suspicion that assets derive from a crime. The reference to 'federal authority designated by the law' is a reference to the Money Laundering Reporting Office Switzerland (MROS) at the Federal Office of Police (fedpol) that was established on 1 April 1998. The financial intermediary—under the old law—could choose whether it notified the penal prosecution authorities or MROS. This, however, led to the situation that the MROS—an authority specialized to perform a preliminary analysis—was contacted more scarcely as would have been desirable. The benefit of directly contacting the MROS instead of a cantonal penal prosecution authority safeguards that the notifications are actually recorded—a fact that is said to positively influence the reputation of the financial sector in Switzerland—and that the process of elaborating whether the suspicion was justified or not is accelerated.

Since 1 February 2009, notification of any suspicion that assets derive from a crime have to (or can) be reported to the MROS only—and not to the cantonal penal prosecution authorities.

b) New Predicate Offences

i. Falsification of Goods

Another change in force since 1 February 2009 is the revised qualification of professional falsification of goods pursuant to article 155 PC as a crime *(Verbrechen)* rather than as a mere offence *(Vergehen).* According to article 155 (2) PC, whosoever professionally, for the purpose of deceiving others in business relationships, produces merchandise of which the real value is falsely represented, particularly by counterfeiting or falsifying goods, or imports, stores, or brings such goods into the stream of commerce, shall now be punished with imprisonment of up to five years or a fine unless the offence is, according to another provision, punishable with a more severe sentence. Other than simply tightening the maximum penalty from three to now five years of imprisonment, falsification of goods ***now qualifies as a so-called predicate offence*** within the meaning of article 305bis PC (*i.e.,* money laundering).

ii. Levy Fraud

Also qualified levy fraud *(qualifizierter Abgabenbetrug)* or organized contraband trade *(bandenmässiger Schmuggel), i.e.,* levy fraud or smuggling that either is intended to obtain substantial proceeds or is committed within the framework of a criminal gang, ***now is a predicate offence for money laundering.*** Article 14 (4) of the Administrative Penal

Code that was newly introduced in the Administrative Penal Code, provides for a penalty of up to five years imprisonment or a fine and, hence, introduces a new crime.

c) Changes in the Anti Money Laundering Act

i. Subject-Matter of the AMLA

According to the revised article 1 of the Anti Money Laundering Act (AMLA), the AMLA now not only governs the fight against money laundering, but also the fight against financing terrorism within the meaning of article $260^{quinquies}$ PC. In order to comply with this new purpose, additional duties of diligence were introduced that now also deal with the fighting against the financing of terrorism.

To ensure that this ***new purpose*** is reflected in the law, several provisions of the AMLA, namely articles 3, 6, 8, 9, 21, 23, 27 and 32 were amended and now not only refer to money laundering but also expressly mention the financing of terrorism in respect of which, for example, suspicious facts lead to a duty to verify the identity of a party to a contract with the financial intermediary or where the financial intermediaries must notify the MROS. Most of these changes merely implement the *status quo* that—until 1 February 2009—was administered either by teleological interpretation of the law, *e.g.,* article 32 (2) (a) was applied to financing terrorism despite its wording only mentioning money laundering, or by equating terrorist organizations with criminal organizations pursuant to article 9 (1) AMLA.

ii. New Duties for Financial Intermediaries

However, some new duties were introduced by the amendment of the AMLA.

For example, since 1 February 2009, financial intermediaries are under an express obligation to ***verify the identity of a representative of a legal entity and*** to ***verify the proxy*** based on which the representative acts. While, in practice, most financial intermediaries already checked the proxy and the identity of the alleged representative in order to avoid civil liability, the AMLA now provides for an express duty in order to prevent money laundering and the financing of terrorism.

Moreover, financial intermediaries now are under a general obligation to collect ***information regarding the character and the purpose of the business relation.*** Only the extent of this data collection varies from case to case, depending on the risk that the contracting party represents.

In addition, financial intermediaries now are also obliged to notify the MROS in cases where the ***negotiations are discontinued because of knowledge or suspicion regarding money laundering or the financing of terrorism*** and the contractual relationship did not even come into existence. The financial intermediary is, however, not obliged to gather additional information or to start specific investigations.

iii. Facilitations

The revised AMLA not only creates additional duties for the financial intermediaries, but also differentiates between the value of certain assets and the probability of money laundering or the financing of terrorism. In cases where the contractual relationship only affects ***assets of minor value or where there are no suspicious facts*** with regard to said crimes, the financial intermediary can now abstain from complying with the duties of diligence set forth in article 3 to 7 AMLA. However, according to the Federal Councils message, it will be left to the supervisory authority or self regulation to install methods that prevent criminals from placing several amounts that—each individually—do not have considerable value but that—in the aggregate—are of substantial value (so-called smurfing).

Furthermore, the financial intermediary must immediately freeze the suspicious assets, notify MROS and must not inform other persons or entities about the notification to the MROS. However, according to the new article 10a AMLA, the financial intermediary now is allowed to inform another financial intermediary about a notification to the MROS, provided that (i) the notifying financial intermediary is not able to block the assets (which will be most likely in cases of external asset managers), (ii) both financial intermediaries perform services of asset administration to the same customer based on a contractual relationship (*e.g.* the bank informs the external asset manager), or (iii) both financial intermediaries are members of the same group of companies. In all of these cases, however, both financial intermediaries must be subject to the AMLA. In other words, foreign financial intermediaries cannot be informed based on the new article 10a AMLA. The financial intermediary who was informed by the first financial intermediary is subject to the same restrictions and exceptions as the first financial intermediary has been.

Finally, article 11 AMLA now states that financial intermediaries, who notified MROS, ***cannot be held liable*** because of breach of official, professional or trade secrecy or for breach of contract ***if they acted in good faith.*** Before this change, financial intermediaries notifying the MROS could have faced civil or even criminal liability in cases where they had not acted with the 'diligence required in the circumstances'. The less strict standard applied now should encourage financial intermediaries to notify MROS in cases where they—in good faith—think that *e.g.* money laundering could be an issue with respect to the specific client, but have not sufficient information in this regard, yet.

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Weaknesses in the ISDA Master Agreement and the ISDA CSA

Reference: CapLaw-2009-21

Lehman Brothers Holdings Inc. filed for Chapter 11 bankruptcy on 15 September 2008, causing the London arm to enter administration and the entire Lehman group to begin to topple. The Lehman bank default has provided a wake-up call. Weaknesses in the International Swaps and Derivatives (ISDA) documentation, previously seen as remote, have become a reality. Major weaknesses in the ISDA Master Agreement include flawed negotiated documentation and harsh termination notice provisions. In the Credit Support Annex (CSA), confusion surrounds the differences in the English and New York forms and re-hypothecation risks.

By Thomas Werlen / Stefan Sulzer

The derivatives exposure of Lehman entities is huge. According to its administrators, the London arm of Lehman Brothers alone had roughly 8,000 ISDA Master Agreements in place, with around 67,000 open trades under them, when it entered administration. Until then the ISDA Master Agreement and the CSA had coped admirably with insolvencies of market participants; however, none of these stress tests involved the default of a leading financial institution and derivatives market maker. The Lehman bank default has laid bare significant weaknesses in the ISDA documentation:

Triggering a Default. In the last few years many counterparties have entered into derivatives transactions with language incorporated into the confirmation that the parties will use reasonable efforts to negotiate an ISDA Master Agreement; however, the counterparties often neglected to subsequently enter into such agreement. Problems arise when the counterparty is a subsidiary of a parent that files for bankruptcy. In the case where the parent company files for bankruptcy prior to the contracting subsidiary, the counterparty is left unable to trigger a default until the subsidiary files for bankruptcy. Where a negotiated ISDA Master Agreement is already in place, this would be unlikely to cause a problem as the parties would usually name the parent company as a credit support provider or a specified entity in the schedule, which would allow the non-defaulting party to trigger an event of default as soon as the parent company filed for bankruptcy. This issue may be addressed by a specific ISDA protocol providing that any group parent company or subsidiary issuing or taking on capital markets debt would be considered a specified entity for the purposes of a bankruptcy event or default pursuant to Section 5(a)(vii) of the ISDA Master Agreement.

Termination Notice. Notices under an ISDA Master Agreement can be sent in a variety of ways: by post, fax, telex, electronic messaging system and, in the 2002 ISDA Master Agreement, also by email. Notwithstanding these provisions, notice of an event of default cannot be given by email and, if given by fax, must be in legible form and received by a responsible employee of the recipient. The onus of proof is on the sender, which effectively rules fax out as a certain form of delivery. Hand delivery of a termination notice is the only certain means of designating an event of default. If a party attempts to terminate an ISDA Master Agreement by sending notice by email or illegible fax, the positions will remain open. The consequences of a mistake seem to be particularly harsh. This issue may be addressed by signing up to an ISDA protocol allowing delivery of a notice of event of default by fax or email to be considered valid if related to bankruptcy of the counterparty, or a specified entity which is a parent company.

English and New York CSA forms. Although there is just one form of ISDA Master Agreement that is applicable under both New York and English law, the same is not true of the CSA, which has different forms for these jurisdictions. A lack of market understanding of the key differences between the forms, particularly in relation to rights in transferred collateral, exacerbated problems in the recent wave of market defaults. The effect of choosing one form over the other may have a significant effect on the treatment of collateral following a close-out. Under an English law CSA, any collateral listed as 'Eligible Collateral' is delivered to the other party by an outright transfer of title. The collateral taker becomes the outright owner of that collateral free of any interest or liens of a third party and is free to dispose of it. The collateral taker must give back equivalent collateral, although crucially it does not have to be the identical collateral, if and when the exposure reduces. Under a New York law CSA, the collateral provider retains a first ranking security interest in transferred collateral, helping to reduce the risk of a movement in mark-to-market exposure accompanied by a default, prior to the delivery or return of collateral. The effectiveness of this security interest is reduced and often negated by allowing the collateral taker to re-hypothecate the collateral (see further below). Each form has its own advantages and disadvantages: the English law CSA transfers title completely, whilst the collateral provider under the New York CSA retains a security interest in the transferred collateral. The central weakness of both forms is the reluctance to use a third party custodian to hold the posted collateral.

Re-hypothecation. Despite the first priority interest and lien retained over the collateral by the collateral provider, the New York CSA permits re-hypothecation *(i.e.* the collateral taker to transfer the collateral to a third party free of encumbrances, to cover its own exposures under separate derivatives agreements). This default position, as set out in paragraph 6 (c) of the New York CSA, exposes the collateral provider to the risk that the collateral taker becomes insolvent and prior to the collateral provider designating an early termination date under the ISDA Master Agreement, the mark-to-market exposure moves back to the collateral provider. The collateral provider may then find that the securities it believed it had a security interest over, had previously been transferred to a third party, who can now set these off against its own exposure to the bankrupt entity. Parties should consider the risks of re-hypothecation and consider disapplying the provisions in the New York form which make this possible.

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Regulating Credit Default Swaps

Reference: CapLaw-2009-22

The global financial crisis and the greater focus on counterparty risk after the collapse of Lehman Brothers have increased calls to clear Credit Default Swap trades through a central counterparty.

By Thomas Werlen / Stefan Sulzer

Credit Default Swap (CDS) contracts are typically entered into over-the-counter (OTC) and cleared bilaterally. Unlike most interest rate swaps, CDSs can result in large payments to be made in the event of a bankruptcy of the relevant company. The greater focus on counterparty risk after the collapse of Lehman Brothers, a major counterparty in the derivatives market, has increased calls to clear CDS trades through a central counterparty (CCP). A CCP stands between the buyer and the seller and bears the risk of either party failing.

Several initiatives have been taken to address the issue of CCPs:

Cooperation among regulators. Representatives from the U.S. Federal Reserve, the U.S. Commodity Futures Trading Commission, the U.S. Securities and Exchange Commission, the U.K. Financial Services Authority, the German Federal Financial Services Authority (BaFin), Deutsche Bundesbank, the European Central Bank and others held meetings in January and February 2009 to discuss possible information sharing arrangements and other methods of cooperation within the regulatory community for central clearing of CDSs.

Larosière report. A high-level panel led by Jacques de Larosière, the former head of the International Monetary Fund, was established in November 2008 to review the European Union's financial regulation and to recommend changes in response to the global financial crisis. The panel presented its findings and recommendations at the end of February 2009. The panel's recommendations include the simplification and standardization of OTC derivatives and the introduction of at least one central clearing mechanism in the EU for CDSs.

Commitment to use CCPs. Nine brokers (Barclays Capital, Citigroup Global Markets, Credit Suisse, Deutsche Bank, Goldman Sachs, HSBC, JPMorgan, Morgan Stanley and UBS), the International Swaps and Derivatives Association (ISDA) and the European Banking Federation have confirmed their intention to use an EU-based central clearing system for eligible CDS contracts in the European Union by the end of July 2009.

CCPs. IntercontinentalExchange (ICE), an operator of regulated global futures exchanges and OTC markets, announced that it will begin clearing European CDS trades by July 2009 through a new entity called ICE Trust Europe. In the US, ICE has recently started clearing CDS transactions with Markit-indices for North America and awaits regulatory approval to clear single CDS trades within the next few months. European clearing house LCH.Clearnet also announced its intention to launch a eurozone CDS clearing service, which will be managed by its French subsidiary, by December 2009.

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Infringement of Disclosure Obligations: FINMA Ruling in Sulzer Case

Reference: CapLaw-2009-23

In a decision dated 22 January 2009, the Swiss Financial Market Supervisory Authority (FINMA) has ruled that Ronny Pecik sen. and Georg Stumpf, acting as an organized group, infringed the disclosure obligation of article 20 of the Stock Exchange Act when building their stake in Sulzer AG in 2006/2007. FINMA, after having completed a comprehensive investigation, found that Ronny Pecik sen. misused options which formally provided for cash settlement and converted cash-settled options into physically-settled options to acquire Sulzer shares, thereby gaining potential control over the voting rights in respect of the shares as well as the physically-settled options. Such indirect acquisition is also subject to the disclosure obligations of the stock exchange legislation which FINMA has found to be violated. As a result, FINMA will file a criminal complaint with the Federal Department of Finance.

In another ruling pertaining to the Sulzer case, FINMA held that the Zurich Cantonalbank, in assisting Ronny Pecik sen. in the stake-building process, seriously infringed its obligations. The procedures relating to Deutsche Bank, Zurich branch and NZB Neue Zürcher Bank are still pending.

(full press release at *http://www.finma.ch/e/aktuell/pages/mm-sulzer-20090126.aspx)*

Finanzmarktenforcement (Financial Market Enforcement)

Tuesday, 26 March 2009, 11:30 a.m.–2:00 p.m.

Zunfthaus zur Meisen, Münsterhof 20, 8001 Zürich

Chair: Dr. Stefan Breitenstein

Panelists: Dr. Martin N. Burkhardt, Dr. Peter C. Honegger, Dr. David Wyss,

Further information and registration on *http://www.amcham.ch.*

Entwicklungen im Finanzmarktrecht VI (Developments in Financial Markets Law)

Tuesday, 5 May 2009 (registration period ends 14 April 2009)

Lake Side Casino Zürichhorn, Zurich

Chair: Prof. Dr. Urs Bertschinger, Zurich, Prof. Dr. Rolf Watter, Zurich

Speakers: Lionel Aeschlimann, Prof. Dr. Urs Bertschinger, Christoph Bigger, Dr. René Bösch, Dr. Patrick Hünerwadel, Prof. Dr. Rolf Watter, Dr. David Wyss

Further information and registration on *http://www.eiz.uzh.ch.*

41st International Capital Market Association Annual General Meeting and Conference

Wednesday, 3 June–Friday, 5 June 2009 (registration opens March 2009)

Palace Hotel, Montreux

Further information and registration on *http://www.icma-group.org.*