

Proposed amendments of Swiss disclosure rules to close raider loopholes

by Alexander Vogel and Christoph Heiz, Meyer Lustenberger

PROMPTED BY A NUMBER OF RECENT CASES, WHERE RAIDERS HAVE SECRETLY BUILT UP SIGNIFICANT STAKES IN SWISS LISTED COMPANIES AND THEN SUDDENLY CONFRONTED BOTH THE TARGET AND THE REMAINING SHAREHOLDERS WITH A DOMINATING MINORITY STAKE, THE SWISS FEDERAL BANKING COMMISSION ('SFBC') AND THE SWISS FEDERAL PARLIAMENT ARE ACCELERATING THE IMPLEMENTATION OF TOUGHER DISCLOSURE RULES. SUCH NEW RULES WILL IN PARTICULAR ALSO AIM AT CERTAIN DERIVATIVE STRUCTURES USED BY RAIDERS TO AVOID EARLY DISCLOSURE OF THEIR PLANS.

Current legislation

Up to now, anyone building up a stake in a company with its registered office in Switzerland listed on a Swiss stock exchange, must publicly disclose the holding of more than 5% in such listed company's shares or options. According to Article 20 of the Stock Exchange Act ('SESTA'), further reporting requirements are triggered once the stake exceeds or falls below the threshold percentages of 10, 20, 33 1/3, 50 or 66 2/3 of the voting rights. In addition, the stakes of parties acting directly or indirectly in concert have to be aggregated and to be reported on such aggregate basis. The obligation to disclose significant shareholdings aims on the one hand to ensure equal treatment of market participants through improved transparency with respect to price sensitive shareholding structures, i.e. to prevent information advantages which can be abused by a potential raider. On the other hand, the reporting obligations are designed to prevent clandestine acquisitions by way of creeping tender offers as well as the clandestine sale of significant shareholdings on or off

the stock exchange. Violation of the obligation to report a qualified shareholding in a listed company can result



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in a fine that can be set at an amount up to the double of the purchase price or the sale proceeds. The amount of the fine is calculated based upon the difference between the new shareholding held by such acquirer and the last shareholding reported.

The reporting obligations are triggered by obtaining a contractual right to acquire the shares, regardless of whether the voting rights of any acquired shares can be exercised. Conversely, the completion of the purchase or sale transaction is irrelevant for reporting purposes, but relevant for the triggering of the obligation to submit a public offer to the remaining shareholders in case that a party's or such group's stake exceeds the threshold percentage $33 \frac{1}{3}$ of the voting rights (unless the articles of incorporation of the target set out either an increase or an abolition of the obligation to submit a public offer). Regarding options or other derivatives, an additional reporting has to be made if the shareholding reaches, exceeds or falls below one of the mentioned thresholds in the event of their exercise or non-exercise.

The threshold values in Article 20 SESTA are defined on the basis of the total number of voting rights registered in the commercial register of the target (Article 10 para. 2 of the SFBC's Ordinance on Stock Exchanges and Securities Trading, 'SFBC-Ordinance'). The same regulation provides so far that only the acquisition or sale of conversion and acquisition rights, in particular call options, and the writing of share sale rights, in particular put options, need to be reported, to the extent these options provide for or allow a physical settlement. Thus, currently only the acquisition and sale of call options and the granting of put options are subject to the obligation requirements, not, however, the acquisition and sale of put options and the writing of call options.

In addition, the regulation sets out that the acquisition or sale of call options or similar acquisition rights and/or the writing of put options or similar sale rights on less than 5% of voting rights is exempt from the reporting obligations under Article 20 SESTA regardless of the percentage of the pre-existing shareholding of the party entering into the transaction. A party is only under an obligation to report

in case that as a result of exercising its option a threshold percentage is being reached or exceeded. Thus, the current regulation allows a potential acquirer to combine the acquisition of 4.99% of the shares of the target with the acquisition of call options on also 4.99% of the target's shares without having to report such holdings.

Further, the SFBC-regulation limits in its Article 13 para. 1 any reporting obligations to options which provide for or allow physical settlement and exempts options providing for cash settlement from such reporting obligations, at least to the extent the cash settlement is the exclusive way to settle the option. However, this rule has led in the last few months to the abuse of cash settlement options by raiders to quietly build up large stakes without the risk that the price would rise accordingly. In practise, the raiders usually requested several banks or securities dealers to sell cash-settlement options with an implicit or even explicit agreed possibility to request a physical instead of cash settlement at the end of the term. Similar constructions can also be achieved with total return swaps or (other types of cash-settled swaps with embedded physical options or forwards) that are combined with an implicit or explicit agreement that the client can acquire the shares, forwards or option positions which the bank obtained to hedge its end of the swap (or other derivative transaction) as the total rate of return payer.

If a potential raider enters into several similar transactions with different banks and/or securities dealers each of them with an aggregate number of shares in the target below 5% as the underlying, each of the banks or securities dealers acting as counterparty acquiring the underlying shares of the target to hedge its position, the raider will be in a position to acquire at the term of these derivative transactions a significant stake of the target without reporting any stake during the building up period of such stake and thus without giving the other shareholders notice of its increasing interest in the target company as he would have to give if he had acquired the shares as 'normal' long positions or long call options.

Already under the existing rules, it can be argued that only call options, swaps and forwards exclusively allowing

physical settlement are exempt under Article 13 para. 1, i.e. any implicit or even explicit arrangement that the bank's client has a right or option to request physical delivery rather than the agreed upon (and documented) cash settlement of such option, forward or swap would bring such derivative transaction under the reporting requirements provided for in Article 20 SESTA. However, so far there has neither been any case law nor any clear guidance by the regulator whether or not such transactions need to be disclosed to the target and to the stock exchange. Further, if the bank or securities dealer knew or should have known based on the circumstances, that the client intends to build up a significant stake in the target, there is already under the current legislation a considerable risk that the regulator could argue, the different banks or

securities dealers and the client have to be considered as a group and thus have to report on an aggregate basis.

Proposed new regulations

In a concerted effort of the Federal Parliament and the SFBC as the regulator to close such loopholes that have allowed the raiders to sneak up on several Swiss companies in the past months, a change of Article 20 as well as the implementing regulations has been proposed.

On the one hand, one chamber of the Federal Parliament has already approved an amendment of Article 20 SESTA that would decrease the lowest percentage threshold triggering a reporting requirement from 5% to 3%. The second chamber is scheduled to debate the amendment in its summer session



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starting in July. The amendment, if passed, is scheduled to enter into force in mid autumn of this year. Further proposed changes include the consequences of a violation of the reporting requirements: in particular, the supervisory authority, the target company or a shareholder can request that the voting rights of an acquirer that did not disclose its shareholding according the relevant provisions are temporarily or – if the acquisition was made with the intention to subsequently submit a tender offer - permanently suspended. The Parliament also discussed a further amendment which would further define the notion of indirect acquisition. Such definition would then explicitly also include any other transaction or agreement, in particular option, swap or similar transactions, which a person enters with the view to subsequently launch a tender offer, even if such transaction or agreement does not provide for a firm entitlement to request the sale of the shares. However, the Parliament decided to leave it up to the Federal Council and the SFBC to close any possible loopholes since the intent of the statute to enforce full disclosure of any indirectly held stakes – to the extent they reach a certain threshold – is clear and details are better dealt with in the implementing ordinances.

In that context it is worthwhile to note that the Swiss Takeover Board qualified in its Saurer decision of October 31, 2006 certain call option and call spread warrant positions entered into by the subsequent acquirer – even before exercised or otherwise settled – as indirect acquisitions of the underlying shares and thus triggering not only reporting obligations, but in addition also the obligation to submit a mandatory tender offer.

On the other hand, the SFBC has published in mid April of this year a proposal for several amendments to the SFBC-Ordinance which would in particular delete the existing exemption for cash-settled options in its entirety and would require the aggregation of all acquired positions in the underlying and any derivatives and thus would eliminate the possibility to acquire 4.99% of the shares of the target and at the same

time of up to 4.99% in long options without having to disclose such stake. Further, the amendment would also introduce a reporting obligation for the acquisition and sale of put options or other rights to sell the underlying and the writing of call options (or the granting of other rights to acquire the underlying) which, as described, have been exempt so far from the obligation to disclose. The SFBC has announced that it intends to issue these amendments of the SFBC-Ordinance by the end of June 2007 which would allow that they enter into force as per July 1, 2007. Due to these changes – in particular the exemption for cash-settlement derivatives -, also cash-settled swaps with or without any embedded physical options or forwards relating to the underlying will have to be disclosed if the notional amount, i.e. the notional number of shares exceeds – together with any other direct or indirect positions held and together with any derivative positions held – any threshold percentage. It is still unclear to what extent a netting of positions, e.g. call options and put options on the same underlying, will be possible.

So far, the prevailing view seems to be that any netting possibility shall not allow any potential raider to disguise its holdings in the target. Further guidance on that issue can be expected from the further amendments of the SFBC-Ordinance to be issued after the entering into force of the amendments of the Stock Exchange Act in mid-autumn of this year. In the meantime, banks and securities dealers should be wary of clients with a potential intent to obtain control of a target company by means of derivative transactions in order to avoid the risk of being considered as a party acting in concert with the client. They could become jointly and severally liable for potential fines if the client does not fulfil its reporting obligations or, in the worst case, could be obliged to participate in a tender offer for the target company at a minimum price which will have to take into consideration – as the Swiss Takeover Board decided in the Saurer case – the value of any options, other derivatives or similar rights obtained or granted by the acquirer.