

RVP Bulletin

How to avoid Regulations for Private Equity Investments in Switzerland



Dr. Alois Rimle, LL.M.
rimle@rvpartner.ch

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Alfred Gilgen, LL.M., N.Y. BAR
gilgen@rvpartner.ch

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Supervisory law question

Private equity investments

Private equity means the method of financing that provides non-listed companies in a decisive phase of their development with mid- and long-term equity and if needed management support. There is the intention from the beginning to again sell the participation in order to realize risk equivalent profit.

Private and institutional investors provide actual risk capital (e.g. shares) or quasi risk capital (e.g. "participating" loan) for a limited period of time of generally a few years. For such purpose they directly or indirectly take an interest in a company to be incorporated or an already existing company, the shares of which are not listed (*private equity financing*).

The ownership or target company of a private equity structure in Switzerland is often a stock corporation pursuant to the Swiss Code of Obligations (CO). It may also be a limited liability company or a limited partnership pursuant to the CO.

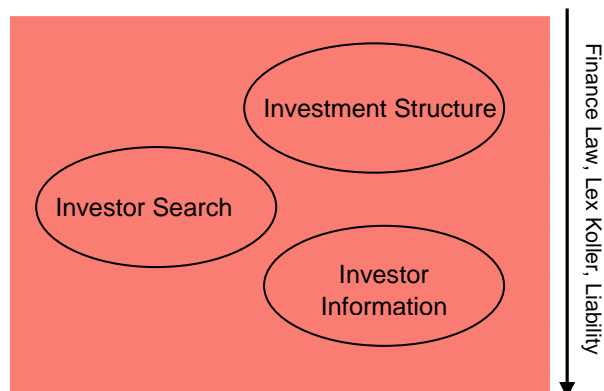
Supervisory law restrictions

The supervisory law limits serve (among others) the protection of the investors. In particular, private equity investments in Switzerland are subject to supervisory law restrictions. Various activities in the context of private investments are reserved to regulated and supervised companies that comply with specific legal requirements. Any person who does not hold the required license or does not comply with the legal requirements, risks facing supervisory law or criminal law sanctions or is possibly subject to statutory liability.

Any person who searches investors for private equity investments and does not hold any supervisory law license must structure the investment in such a way that no investor protection provisions apply and no license from FINMA is required. The application of finance laws and other laws that serve the protection of investors must be avoided. The relevant laws include first of all the Collective Investment Schemes Act, the Stock Exchange Act, the Banking Act and the prospectus provisions of the Code of Obligations. In addition, particular laws may apply to private equity investments. For example, Lex Koller (Federal Law on the Acquisition of Real Estate by Persons Abroad) is applicable if Swiss real estate and persons abroad are involved.

In order to avoid the application of supervisory law restrictions, one must observe various statutory requirements for the structuring of private equity investments. In particular, there are requirements for the actual investment structure, the search for appropriate investors and the information of investors. In the event of non-Swiss investors, it should be noted that additional requirements may need to be observed.

Topics and legal areas in connection with non-regulated private equity investments may be shown as an overview as follows:

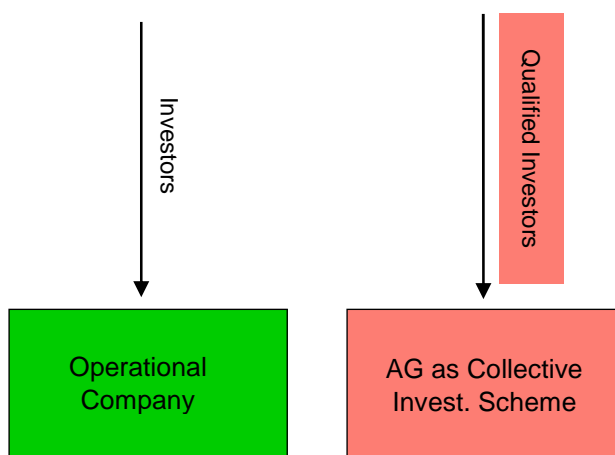


Non-regulated Investment Structure

Two structure alternatives

The question on how to set up private equity structures in order to avoid regulations substantially concerns the application of the Collective Investment Schemes Act (CISA). Two alternatives need to be considered: Either the ownership company is structured such that it qualifies as *operational company* and not as collective investment scheme in the sense of CISA, or the investment opportunity is restricted such that only *qualified investors* in the sense of CISA are allowed to invest.

The two structuring alternatives may be shown as an overview as follows:



Operational company

CISA applies to all funds (as collective investment schemes), irrespective of their legal form, raised from investors for the purpose of collective investment, and which are managed for the account of such investors, provided that the investment requirements of the investors are met on an equal basis (Art. 7 para. 1 and Art. 2 para. 1 CISA). As an exception, CISA does not apply to operational companies. It follows that CISA does not apply to private equity structures if the ownership company qualifies as operational company.

One may ask the question as to how one distinguishes between collective investment scheme and operational company or the question on how an *operational company* is defined. The question is controversial among legal writers and in legal practice. Neither the law nor the relevant ordinance respond to the question under which conditions a company is considered as operational active or performs entrepreneurial activities and therefore is not subject to CISA. According to a recent Supreme Court decision of November 2010, the delimitation between collective investment scheme and operational company requires an overall view in any particular case. Several delimitation criteria shall be taken into consideration, for example the scope of discretion of the management regarding the investment policy, the convertibility of the risk profiles of the investors, the kind and degree of representative participation of the investors, the statutory purpose, the origin of the means, the organisational degree and the organisational form, the kind of risk (operational risk or market and investment risk) as well as the market appearance vis-à-vis the investors. As supporting criteria the subjective view of the investors regarding the intended use of their assets and the number of investors may be taken into consideration (Decision of the Supreme Court 2C_271/2009 of November 5, 2010). The delimitation between operational company and collective investment scheme is eventually based on a judgemental balance taking into consideration investor protection as the purpose of the law. If the delimitation is unclear it may be advisable to ask FINMA for a ruling.

Qualified investors

Due to a difficult delimitation between operational company and collective investment scheme, one may ask the question whether there are other ways to avoid the application of CISA to private equity structures. An alternative approach is to restrict the investment opportunity and make it available to qualified investors only. Investment companies in the form of stock corporations are not governed by CISA if only shareholders as defined in Art. 10 para. 3 may invest in them, if the shares are registered, and if auditors recognized by FINMA confirm on an annual basis that these requirements have been met (Art. 2 para. 3 CISA).

The qualified investor approach in order to avoid the application of CISA is available for stock corporations, however, not for limited partnerships. The application of CISA to a stock corporation (in the form of a SICAF) may be avoided if the investment opportunity is restricted to qualified investors (Art. 110 CISA). In the case of a limited partnership subject to CISA, however, the limited partners must be qualified investors; it is merely based on the exclusive purpose of collective investment (Art. 98 CISA) that a limited partnership is considered as a limited partnership for collective investments subject to CISA.

Qualified investors in the sense of Art. 10 para. 3 CISA are not only banks, other supervised institutions and companies with professional treasury operations, but also high-net-worth individuals and investors with managed assets. *High-net-worth individuals* are investors who confirm in writing to a bank or certain other supervised institutions or to a professional asset manager that they directly or indirectly hold financial investments of at least 2 million francs at the time of investment (Art. 6 para. 1 CISO). *Investors with managed assets* are persons who have entered with a bank or a professional asset manager (independent asset manager subject to Anti-money Laundering Act and to code of conduct of recognized industry association) into a written asset management agreement that complies with the applicable standards of the industry association (Art. 6 para. 2 CISO).

As a result, the application of CISA to private equity structures may be avoided if the ownership company is a stock corporation, the shareholders of which

must be qualified investors (e.g. customers of professional asset managers).

Non-regulated Search for Investors

Avoidance of professional and public nature

Any person who intends to contact potential investors regarding a private equity investment without holding a license from FINMA must structure the search such that no investor protection provisions apply and no license is required.

In particular, the application of CISA, the Stock Exchange Act, the Banking Act and the prospectus provisions of the Code of Obligations needs to be avoided. The relevant application criteria of these laws are the *professional nature* and the *public nature* of the activity. In other words, the relevant laws may apply if the promoters act in a commercial way or publicly promote the private equity investment opportunity.

No public distribution under CISA

Any person publicly offering or promoting units of a collective investment scheme must obtain the authorisation of FINMA (Art. 19 para. 1 CISA). Public promotion pursuant to CISA is defined as any promotion that is addressed to the public. Promotion does not qualify as public if it is addressed exclusively to qualified investors (Art. 3 CISA) or to a closely described circle of persons (Decision of Supreme Court 2C_89/2010 of 20 February 2011).

If the promoter of a private equity structure contacts potential investors exclusively over banks and professional asset managers there is no public promotion, since the potential investors are considered as qualified. CISA does not apply and the promoters do not need any distribution license. If the ownership company accepts exclusively *qualified investors* (as shareholders or limited partners) there isn't any interest to begin with in approaching investors who are not qualified.

Private equity investments may, however, also be available for non-qualified investors without triggering regulation, provided that the ownership company is

an *operational company*. In this case the distribution of units is not regulated, since without collective investment scheme there cannot be any promotion for it. As regards the promotion for the purchase of shares of an operational company, the Code of Obligations exclusively applies (see hereafter).

No issuing house under Stock Exchange Act

Furthermore, the application of the Stock Exchange Act needs to be avoided in case of private equity investments. The issue of units of the ownership company must not take place in a way that the promoter is to qualify as issuing house in the sense of the Stock Exchange Act.

Issuing houses pursuant to Art. 3 para. 2 SESTO are securities dealers who, in a professional capacity, underwrite securities issued by third parties on a firm basis or against commission and offer them to the public on the primary market. Issuing houses must be mainly active in the financial sector (Art. 2 para. 1 SESTO). *Securities* are thereby defined as standardised certificates which are suitable for mass trading, book-entry securities and derivatives (Art. 2 lit. a SESTA). They are considered as standardized and suitable for mass trading if with the same structure and denomination they are publicly offered or placed with more than 20 clients, provided that they are not created particularly for individual counter-parties (Art. 4 SESTO).

It follows that who, in a professional capacity, underwrites shares of a stock corporation (as ownership company of a private equity structure) and then publicly offers them for sale to third parties (for example in the course of seminar activities) qualifies as issuing house and is subject to the Stock Exchange Act. The same applies if the activity of a securities dealer subject to authorisation is performed within a group based on the division of labour: The authorisation requirement and the financial supervision should not be bypassed based on the fact that each single company involved on its own does not combine all elements that require authorisation (FBC Bulletin 51/2008, p. 242 f.; Decision of the Supreme Court 2C_276/2009 of 22 September 2009, FINMA Bulletin 1/2010, p. 19 ff.).

No unauthorised banking activity

The application of the Banking Act also needs to be avoided in case of private equity investments. Natural persons and legal entities which are not subject to the Banking Act may not accept deposits from the public on a professional basis (Art. 1 para. 2 BA). Those who accept on a continuing basis more than 20 deposits from the public are considered to be acting on a professional basis within the meaning of the Banking Act (Art. 3a para. 2 BO). The persons who are not subject to the Banking Act may not make publicity in any form for such deposits, in particular in advertisements, prospectuses, circulars or electronic media pursuant to Art. 3 para. 1 BO. The Supreme Court states in a decision of 2007 that a person also acts on a professional basis in the sense of Art. 3a para. 2 BO who publicly offers to accept deposits, even if less than 20 investments result thereof (Decision of the Supreme Court 2A.712/2006 of 29 June 2007).

Based on Supreme Court decisions the Federal Administrative Court had to decide in a case where alleged shares not subject to any loss risk were sold and then sold back for at least the purchase price. The Court stated in its decision that the consideration of the purchasers was to be qualified as deposit and, therefore, an activity subject to authorisation pursuant to the Banking Act was performed without permission. The same applies if the activity that is not permissible under the Banking Act is performed within a group based on the division of labour: The authorisation requirement and the financial supervision should not be bypassed based on the fact that each single company involved on its own does not combine all elements that require authorisation (Decision of the Federal Administrative Court B-2474/2007 of 4 December 2007, FBC Bulletin 51/2008, p. 249 f.; FINMA Bulletin 1/2010, p. 19 ff.).

The Federal Administrative Court had to decide in another case where six loan and investment agreements had been entered into and thereby a professional intermediary involved. The Court stated in its decision that the activity was of a commercial nature and that it was performed without permission, although subject to authorisation pursuant to the Banking Act. When assessing the acceptance of deposits, the Court treated several companies as uniform

group (Decision of the Federal Administrative Court B-1645/2007 of 17 January 2007, FBC Bulletin 51/2008, S. 216 ss.; Decision of the Supreme Court 2C_276/2009 of 22 September 2009, FINMA Bulletin 1/2010, p. 19 ss.).

No public offering of shares for subscription

In public equity investments one may also wish to avoid the duty to publish a prospectus pursuant to the Code of Obligations. If new shares of a stock corporation are publicly offered for subscription the company is required to publish an issue prospectus that includes various statutory information. Any invitation for subscription is thereby public, unless addressed to a limited group of persons (Art. 652a para. 1 and 2 CO). If upon issue of shares statements have been made or disseminated which are incorrect, misleading or not complying with the legal requirements for issue prospectuses or similar instruments, anyone having intentionally or negligently contributed thereto is liable to the acquirers of the shares for any damage caused thereby (Art. 752 CO).

The duty to issue a prospectus and the prospectus liability may be avoided if the shares are not publicly offered for subscription but rather privately placed. Whether or not the shares are publicly offered is to be decided based on the qualitative indefiniteness or infinity of the relevant group of persons. Where exactly the line needs to be drawn between public offering and private placement is disputed. The way of issuing shares, therefore, needs to be analysed in detail in order to determine whether it is public offering or private placement.

Non-regulated Information of Investors

Avoiding duty to issue prospectus

There is no duty to provide an issue prospectus pursuant to Art. 652 CO in a situation where a stock corporation in Switzerland acting as ownership company of a private equity structure does not publicly offer but only privately place shares. Furthermore, if no investment vehicle subject to regulation (e.g. SICAF) is interposed, there is no duty to issue a prospectus

under the Collective Investment Schemes Act (e.g. Art. 116 CISA).

Private Placement Memorandum

Even if no duty to issue a prospectus under Swiss law applies, it is still customary to inform investors voluntarily by means of a private placement memorandum. The question is then how such a placement memorandum for the purpose of investor information should look like.

Prospectus liability in Switzerland also applies to prospectus similar documents that have been issued in situations where there is no statutory duty to issue a prospectus. This applies in particular to a placement memorandum that has been issued voluntarily in the course of a private placement. For example, there may be liability based on wrong or misleading statements. As a result, a private placement memorandum must include correct and complete information in order to avoid liability to investors. The rules of prospectus formation may be applied by analogy to the arrangement of private placement memoranda.

Further Restrictions for Investors Abroad

Additional requirements for investors abroad

If persons abroad invest in Swiss private equity structures additional supervisory law restrictions must be observed. If the structure (among others) serves the investment in privately used Swiss real estate, additional requirements may apply based on Lex Koller. Furthermore, non-Swiss supervision law may apply if investors abroad are approached regarding the investment opportunity.

Real estate limit (Lex Koller)

There are additional limits for non-Swiss investors if the private equity structure directly or indirectly concerns privately used real estate. The so-called Lex Koller is applicable, the purpose of which is to limit the acquisition of real estate by persons abroad in order to avoid the foreign infiltration of domestic ground (Art. 1 Lex Koller). Persons abroad generally require a permit of the appropriate cantonal authority

for the acquisition of Swiss real estate. There is exceptionally no need for a permit if the real estate is used for business purposes (permanent establishments, e.g. manufacturing premises, warehouse facilities, offices, shopping centres, retail premises, hotels, restaurants, etc.; Art. 2 Lex Koller). The delimitation between real estate used for business purposes that is not subject to authorisation and privately used real estate that is subject to authorisation may be difficult in the event of hybrid hotels and residence projects. Such projects regularly need a ruling.

As persons abroad are also regarded legal entities, while having their registered office in Switzerland, are controlled by persons abroad. Control by persons abroad is specifically presumed when more than one third of a company's capital or over one third of the voting rights is in their hands (Art. 5 and 6 Lex Koller). This applies also to the ownership company of a private equity structure.

It follows for private equity structures with investors abroad that additional restrictions under Lex Koller may apply if direct or indirect investments in privately used real estate are intended.

Foreign law

If investors abroad are approached regarding private equity structures in Switzerland, additional supervisory law requirements in the relevant country may be applicable and need to be observed. The finance law rules abroad may deviate from the finance law rules in Switzerland and may apply earlier when potential investors are approached. If for example a private placement memorandum is sent to potential investors abroad (if at all permitted) foreign requirements possibly apply to the content of the placement memorandum or foreign liability rules may need to be observed (see position paper of FINMA regarding legal and reputational risks in the cross-border financial services business of 22 October 2010; FINMA Bulletin 1/2010, p. 102 ss.).

Abbreviations

AoA:	Articles of association
BA:	Federal Act on Banks and Savings Banks of 1934 (Banking Act)
BO:	Implementing Ordinance on Banks and Savings Banks of 1972 (Banking Ordinance)
CISA:	Federal Act on Collective Investment Schemes of 2006
CISO:	Federal Ordinance on Collective Investment Schemes of 2006
CO:	Swiss Code of Obligations of 1911

FBC:	Federal Banking Commission
FINMA:	Swiss Financial Market Supervisory Authority
Lex Koller:	Federal Act on the Acquisition of Real Estate by Persons Abroad of 1984
SESTA:	Federal Act on Stock Exchanges and Securities Trading of 1995 (Stock Exchange Act)
SESTO:	Ordinance on Stock Exchanges and Securities Trading of 1996 (Stock Exchange Ordinance)
SICAF:	Swiss investment company in the form of a Swiss stock corporation

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