SWITZERLAND

New Standards Set For Allocation Of Securities Via Public Offerings

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The Swiss Bankers Association ("SBA") recently promulgated new directives for the allocation process for equity-related securities offered by way of a public offering in Switzerland (the "Allocation Directives"). Their prime focus is to ensure principles of fairness and transparency in the allocation process. This self-regulatory measure on the part of the banks has been accepted by the Swiss Federal Banking Commission ("FBC") as a binding minimal standard. The Allocation Directives will become effective on January 1, 2005.

The Allocation Directives define rules of conduct for the allocation process and apply to all public issues and placements of shares, participation certificates and dividend-right certificates, as well as convertible, exchangeable and warrant bonds in Switzerland (the "Allocated Securities"). The Allocation Directives continue to allow for differences in the treatment of individual clients or client groups in line with the need to balance the relative claims of parties involved. However, allocations based on promises of special reciprocal compensation (*e.g.,* laddering, *quid pro quo* agreements and spinning) are explicitly forbidden. Furthermore, offering materials must in future include additional information on any greenshoe options and friends-and-family-programmes. Finally, *nostro* allocations by the underwriting banks (allocations of Allocated Securities to the underwriting banks themselves)–particularly for market-making purposes–are permitted only by arrangement with the issuer and on an appropriate scale.

International (U.S.) Background

Allegedly abusive practices of initial public offering ("IPO") allocations and distributions during the Internet bubble have led to a regulatory response in many jurisdictions. According to a proposal by the National Association of Securities Dealers in the United States ("NASD"), for example, certain abuses are expressly prohibited (*e.g., quid pro quo* allocations, spinning, flipping penalties and acceptance of first-day market orders). Concurrently, the NASD and the U.S. Securities and Exchange Commission ("SEC") have been very active reviewing the allocation and distribution activities of U.S.-registered broker-dealers, and have brought substantial enforcement actions under current laws and regulations in this regard. Furthermore, there have been publicized cases (*e.g.,* involving disproportional *nostro* allocations) in Switzerland as well.

Public Offerings In Switzerland

The Allocation Directives apply only if a public offering of Allocated Securities occurs in Switzerland. The term "public offering" is not explicitly defined under Swiss law. Any invitation to subscribe for Allocated Securities is public unless addressed to a limited group of persons. Material to the public offering is the qualitative indefiniteness of the addressees and the way of contacting those addressees. A vast majority of authors considers a placement to be private if 1) only a limited circle of persons is addressed and/or 2) the investors are contacted individually. Some authors are of the opinion that–as a rule of thumb–an offering qualifies as a private placement if not more than 20 pre-defined persons are contacted individually. However, such quantitative criteria may act as only a first indication for a public offering or a private placement. It should be noted that, under Swiss law, the type of investors being targeted is not relevant for qualification as a private placement or a public offering for Allocated Securities.

However, the SBA seems to take the view that the Allocation Directives would not apply to private equity transactions (even if offered in a "public offering" as defined above), but only to public equity transactions that are publicly offered in Switzerland, which implies that the Allocated Securities must be listed on an exchange, whether in Switzerland or abroad. While this interpretation may not seem very obvious, it is certainly true that historically the preparatory works leading to the Allocation Directives were clearly aimed at public equity transactions, such as IPOs.

Binding Minimal Standards For Banks Active In Switzerland

The Allocation Directives apply to all banks domiciled in Switzerland, including branch offices and subsidiaries of foreign banks that engage in public offerings in Switzerland (each a "Bank"). Circumvention of the Allocation Directives by resorting to parent companies, subsidiaries or branch offices outside Switzerland is prohibited. Even though issued by a self-regulatory organization, the Allocation Directives have been recognised by the FBC as minimal standards for Banks. This means that auditors recognised under regulatory law are required to monitor compliance with the Allocation Directives on behalf of the FBC. Also, explicit reference to the Allocation Directives is made in the current draft of the FBC's Market Abuse Circular *(see report by Rahel Gimmel, of Walder Wyss & Partners, Zurich, at WSLR, June 2004, page 12).*

Allocation Principles And Specific Prohibitions

Generally, the Bank must regulate and document the allocation procedures. They must be based on objective criteria and must be able to be verified by the Bank's competent bodies and employees. Furthermore, the allocation procedures must be transparent to the Bank's licensed auditors and the supervisory authorities, such as the FBC. The Allocation Directives explicitly state (and the majority of legal scholars seems to agree) that there is no legal claim to an allocation. However, allocations against the promise of certain considerations are prohibited. Such prohibitions include, in particular:

- *Quid pro quo* allocations: A prohibition on the offer to allocate, or threaten to withhold allocation of, Allocated Securities in exchange for the receipt of compensation (such as the payment of special commissions or commission premiums) that is excessive in relation to the services provided to the customer by the Bank. In addition, trading activity that serves no economic purpose other than to generate

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compensation for the Bank (*e.g.*, wash sales) would most likely be viewed as "excessive" in relation to the services provided by the Bank, which are meaningless.

- Spinning: A prohibition on the allocation of Allocated Securities to executive officers, directors of a company (or further persons) in exchange for the pledge or specific offer of business orders or propositions to the Bank. Unlike the proposals in the United States, the Allocation Directives do not contain any time limit for compensation already received by the Bank in the past.
- Laddering: A prohibition on the allocation of Allocated Securities to investors in exchange for the pledge to purchase more securities after the placement of the Allocated Securities in the market.

Unlike the proposals in the United States, the Allocation Directives do not contain specific prohibitions on flipping penalties or the acceptance of first-day market orders. Also, unlike the proposals in the United States, the Allocation Directives do not contain any specific requirements to be included in the underwriting agreement and in the agreement among underwriters in respect to the pricing of Allocated Securities.

Allocations To Private Investors

The Allocation Directives continue to allow for differences in the treatment of individual clients or client groups in line with the need to balance the relative interests of parties involved. Any differing treatment of individual private investors has to be justified by legitimate objective criteria including, among others, 1) order size, 2) proportion of subscriptions, 3) random allocations, 4) time of subscription order, 5) long-term commitment to the issuer, 6) investor's portfolio structure, and 7) length of customer relationship. Clearly, to the extent practicable, the most transparent allocation mechanism is a *pro rata* allocation.

Allocations To *Nostro* Accounts

Nostro allocations by the underwriting Banks–particularly for market-making purposes–are permitted only by arrangement with the issuer and on an appropriate scale.

Increased Disclosure Obligations

Offering materials must include additional information on any greenshoe options, including the parties to the over-allotment option, the volume and the maturity of the over-allotment. Transparency is also required in respect of specific allocations requested by the issuer, for example, to business partners or employees (friends-and-family-programmes). Once the transaction has been completed, the lead bank must disclose the placement volume together with the size of allocations to any subscriber categories having special connections to the issuer, as well as any greenshoe options exercised.

Outlook

Most standards contained in the Allocation Directives appear to leave significant leeway for interpretation. This will not necessarily facilitate compliance with the Allocation Directives by the Banks. To be sure, it will not be advisable to change the applicable allocation criteria for every other transaction. Rather, the allocation criteria (such as *pro rata* allocations), once established, should be maintained over a certain period of time.

Arguably, the Allocation Directives may have an impact on the contractual obligation of a lead manager towards its co-managers and syndicate members. In fact, it could be argued that the allocation among co-managers for, *e.g.,* their private clients has to happen on equal terms.

Further, the interpretation of Swiss corporate and contract law by competent courts may be influenced by the Allocation Directives. For instance, spinning, *e.g.,* the awarding of Allocated Securities to the executive officers and directors of an investment banking client, divides the loyalty of the agents of the company (*i.e.,* the executive officers and directors) from the principal (*i.e.,* the company and its shareholders) on whose behalf they must act. This practice is inconsistent with just and equitable principles of trade, and arguably violates legal standards under Swiss corporate and contract law, which may ultimately lead to arguments of *ultra vires* and the potential liability of entities and individuals involved.

Even though the Allocation Directives explicitly state (and the majority of legal scholars seems to agree) that there is no legal entitlement to an allocation, it may be uncertain whether competent courts in all instances would agree with this interpretation in all respects. It would not be the first time that new supervisory standards would influence the application of existing laws by courts.

Overall, the Allocation Directives should make Banks and issuers more vigilant for allocation practices that could be regarded as improper.