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Newsletter

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Dealing with FATF Transparency Rules in the M&A and Advisory Practice

In an unusually fast procedure due to international pressure, Switzerland enacted increased transparency regulations for corporations, which became effective as of 1 July 2015. This FATF legislation is proposed to be further tightened. However, in light of uncertainties in the practical implementation of the existing FATF law, this tightening is premature.

1 TIGHTENING OF FATF TRANSPARENCY RULES *ANTE PORTAS*

As one of over 150 members of the Global Forum on Transparency and Exchange of Information for Tax Purposes (**Global Forum**), Switzerland is committed to implementing internationally agreed standards for transparency and the exchange of information for tax purposes. Compliance with the agreed standards is monitored by the Global Forum through periodic **peer reviews**.

Following the implementation of corresponding recommendations of the Financial Action Task Force (**FATF**) in Art. 697i et seqq. of the Swiss Code of Obligations (**FATF Act**) as of 1 July 2015 and the subsequent peer review, the Global Forum granted Switzerland the overall grade of "largely compliant" in summer 2016, at the same time making additional recommendations on the tightening of the transparency of legal entities.

In view of the forthcoming peer review of the Global Forum, the Federal Council proposes a drastic tightening of the FATF Act: Among other things, **bearer shares for unlisted companies to be abolished** and the introduction of **criminal sanctions** for breaches of the FATF reporting obligations. The consultation on the corresponding draft law of 17 January 2018 (**FATF Revision**) lasted until 24 April 2018. The FATF Revision is currently in the process of being amended and is expected to be newly published on 21 November 2018, followed by parliamentary debates during the spring and summer session in 2019. The finally passed FATF Revision is scheduled to enter into force in October 2019.

The general abolition of bearer shares for unlisted companies would be a drastic measure and would go beyond the objective in view of the transparency provisions already in place in the current FATF law. The introduction of criminal sanctions provided for in the FATF Revision

raises serious constitutional concerns, as the underlying legal provisions on the reporting obligations of shareholders in the current FATF Act are incomplete and unclear, and are thus not suitable to comply with the **general principle of the certainty of criminal law**.

Instead of the planned tightening of the FATF Act, it would thus be more urgent from a legal application perspective to utilize the forthcoming FATF Revision primarily to remedy the shortcomings of the current FATF Act.

2 PRACTICAL HANDLING OF SELECTED OPEN FATF QUESTIONS

When applying the current FATF Act into M&A and advisory practice, **numerous problems** arise with fundamental questions, such as when a reporting obligation pursuant to Art. 697j CO is triggered (Sections 2.1 and 2.2), who must be reported in which constellations (Section 2.3) and how reports are to be made (Section 2.4).

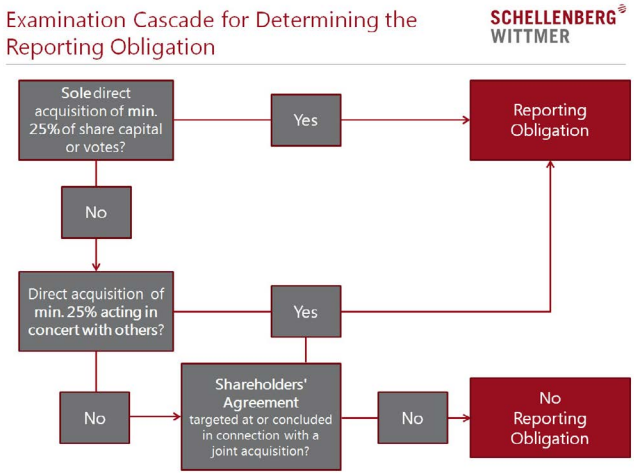
The following is a **rough guideline** on how the cautious addressee of the FATF Act can deal with selected issues that are at the forefront of day-to-day practices in the context of the relevant reporting obligations.

2.1 WHO MUST REPORT?

Among others, any acquirer of shares in a Swiss company (**Target Company**) that is thereby reaching or exceeding the threshold of 25% of the share capital and/or voting rights (**Qualified Shareholder**), is subject to the FATF reporting requirement.

The only decisive factor here is the **direct acquisition** of shares in the Target Company. An indirect acquisition at a higher participation level does not trigger a reporting obligation, but may, under certain circumstances, require an update of an earlier FATF notification.

Not only those who acquire a qualified stake in the Target Company alone, but also those who are doing so **acting in concert with third parties**, are subject to the FATF reporting obligations. However, it is not always easy to judge when such an acting in concert exists. For example, if there is a **shareholders' agreement**, acting in concert triggering the reporting obligation must not automatically be concluded. Rather, such an obligation only exists if the joint acquisition of a qualified stake in the Target Company is the subject matter of the shareholders' agreement in question, or if the same is entered into directly in connection with such a joint acquisition.



2.2 EXCEPTIONS TO THE REPORTING OBLIGATION

There is **no reporting requirement** for the acquisition of shares of Target Companies which are **traded on a stock exchange** or are structured as i**ntermediated securities** within the meaning of the Swiss Intermediated Securities Act.

However, the law does not comment on the question that frequently arises in practice, as to whether this statutory exception also applies if, instead of the Swiss Target Company, **the acquirer** of a qualified stake in a non-publicly listed Target Company, or any of such acquirer's **direct or indirect parent companies**, is a **listed public company** or has **issued intermediated securities**. In our view, the reporting obligation does not apply in either of these cases.

> "The statutory provisions on reporting obligations of shareholders are incomplete and unclear."

This must apply *mutatis mutandis* to the **other statutory exceptions of the reporting obligation** which, according to the wording of the law, relate to the Target Company only. As a consequence, the reporting obligation does in our view not apply if a **public institution**, a **cooperative** or a **non-profit organisation**, directly or indirectly, acquires a qualified stake in a Swiss Target Company.

2.3 WHO IS TO BE REPORTED AS THE ULTIMATE BENEFICIAL OWNER?

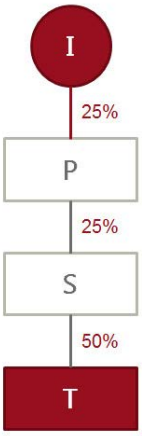
In case of a duty to report, the Qualified Shareholder must report the **individual for whom he or she is ultimately acting (beneficial owner)**.

Again, the law incomprehensibly does not contain any further guidance on this central point of the entire FATF legislation. At least, there is broad consensus that the beneficial owner within the meaning of the FATF Act is primarily the person who ultimately (i.e. directly or indirectly) **controls** the direct shareholder by a qualified majority (**Relevant Threshold**). If several shareholders are each individually below the Relevant Threshold, they may, nevertheless, be regarded as **joint beneficial owners**, such as, e.g., if they are bound into a **shareholders' agreement**, depending on its content.

In Swiss doctrine and practice, there is, however, **no consensus** as to which method should be used to determine the Relevant Threshold in **multi-level participation structures** (i.e. in particular in groups of companies). In particular, the following approaches are advocated, which, depending on the concrete fact pattern, lead to **different results**:

- ***De-Minimis* Method**: According to the most cautious method, the beneficial owners of multi-staged shareholdings must be identified and reported wherever a Relevant Threshold of **at least 25%** of the capital and/or votes is **reached or exceeded** at the **respective level of the participation cascade** above the direct acquirer.

Illustrative Example *De-Minimis* Method:



> Individual I is to be reported to the Target Company T as a beneficial owner

> At each level of the participation cascade, the Relevant Threshold of 25% is reached or exceeded

> Subsidiary S acquires 50% of the shares in Target Company T

- **Multiplication Method**: Here, all direct and indirect holdings of the individual at the end of a participation chain are multiplied by each other. However, the direct participation triggering the reporting obligation (50% of S) is not included in this calculation. The individual concerned is only considered to be a beneficial owner within the meaning of the FATF Act if the **multiplication result** yields a Relevant Threshold of **at least 25%**.

  In the above example, the multiplication of the holdings of I and P results in 6.25%. This means that the Relevant Threshold of at least 25% is not reached. Under the multiplication method, I would thus **not** have to be reported as the beneficial owner.

- **Majority Method**: According to the most liberal method, in the case of multi-tiered ownership structures, the beneficial owners are only to be determined where a Relevant Threshold of **50%** of the capital and/or the votes is **exceeded** at the respective **level of the participation cascade** above the direct acquirer.

  This prerequisite is not fulfilled in the above example. Under the majority method, I would thus **not** have to be reported as the beneficial owner.

In view of the fact that unjustifiably omitted or incorrect reports of beneficial owners may have far-reaching legal consequences - already under the current FATF Act - and, according to the FATF Revision, may even lead to additional criminal sanctions in the future, caution should be exercised in this regard. The *de-minimis* method should therefore be preferred for now.

2.4 IS ALSO TO BE REPORTED IF THERE IS NOT REALLY SOMETHING TO REPORT?

There are again no clear legal requirements as to whether or how a notification must be made if a **beneficial owner** is **missing** or **cannot be identified** or if there is an **exception to the reporting obligation**.

We recommend adhering to the following guidelines in practice:

- **Notification**: A Qualified Shareholder must make a notification if **one or more (individual) beneficial owner(s) has or have been identified**, and if none of the statutory exceptions to the reporting duty applies. If the Qualified Shareholder subject to registration is himself the beneficial owner (individual), this is the subject of the notification.

- **Substitute Notification**: A Qualified Shareholder must submit a substitute notification where either (i) **no beneficial owners exist** or (ii) such beneficial owners exist, but are **not known** or **could not be identified despite careful (reasonable) investigation** by the Qualified Shareholder.

  In such cases, the first and last name and function of the leading member of the **highest management or administrative body of the ultimately controlling legal entity** (or, according to a different doctrine, of the Swiss Target Company concerned) must be reported.

  Under this title, it is first the **CEO**, secondly the **delegate of the board of directors** and thirdly, if no CEO or board delegate exists, the **chairman of the board of directors** that must be reported.

- **Negative Notification**: If and to the extent that there is no **reporting obligation** due to a **statutory exception** (Section 2.2), a Qualified Shareholder should nevertheless make a negative disclosure in which reference is made to the exception in question.

"Notification, substitute notification and negative notification must be distinguished."

Even if the notification or substitute or negative notification is not subject to any formal requirements and may also be made orally, it is recommended that this be made **in traceable form** (i.e. in writing or by e-mail) or that reference is made in the register of beneficial owners to the fact and date of an oral notification.

3 CONCLUSION AND OUTLOOK

In the implementation of the FATF Act, there are numerous open questions in practice to which no concrete answers can be found either in the law, in the materials nor in the case law. The doctrine and practice offer different approaches, which may, depending on the fact pattern in question, result in contradicting results.

In view of the fact that already under the current FATF Act the violation of the reporting obligations results in the **suspension of voting rights** and **forfeiture of the economic rights** of the Qualifying Shareholder concerned, the clarification of these outstanding open questions by the legislator appear to be far more urgent than a radical tightening of the FATF Act.

Moreover, the introduction of criminal sanctions provided for in the FATF Revision cannot be justified from the point of view of the rule of law unless the serious shortcomings in the current legislation are remedied in advance.

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The content of this Newsletter does not constitute legal or tax advice and may not be relied upon as such. Should you seek advice with regard to your specific circumstances, please contact your Schellenberg Wittmer liaison or any of the following persons:

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