

Structured products: Frequently asked legal questions



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Issuers and distributors of structured products were relieved when the Collective Investment Scheme Act of June 23, 2006 (CISA) was finalized: Structured products were barely regulated. Nothing would prevent such products from continuing to be structured and issued within a very short time. In particular, no authorization procedures comparable to those regarding investment funds were foreseen.

Despite the above, there are numerous legal issues to be taken into ac-

count when preparing the launch of structured products for the Swiss market. This article is intended to provide short answers to some frequently asked questions regarding, in particular, the definition, the offering and the listing of structured products.

What are structured products?

No legal definition

It is interesting to note that, although structured products are dealt with explicitly in the CISA and its implementing ordinance, in the Collective Investment Scheme Ordinance (CISO), no legal definition is provided. Indeed, art. 5 CISA merely provides the fol-

lowing examples of structured products: “Capital protected products, capped return products and certificates” – without defining them. Since no binding definition was foreseen in the law, it is often not clear whether certain products fall within the scope of the CISA provisions dealing with structured products or not.

Other definitions

Various participants in the market have issued definitions of structured products. However, it must be borne in mind that none of them are legally binding.

The Swiss Bankers Association has defined structured products in its “Guidelines on Informing Investors about Structured Products” (Investor Information Guidelines) as “investment instruments for which the redemption value is linked to the performance of one or more underlying values. They may have fixed or unlimited maturities and be based on one or more parts, irrespective of weighting”.

According to the Swiss Structured Products Association, “structured products are investment products available to the public whose repayment value derives from the development of one or several underlying assets. Underlying assets are investments such as shares, interest, foreign currency or raw materials such as gold, crude oil, copper or sugar. Structured products are a combination of a traditional investment (e.g. bond) and a derivative financial instrument”.

The “Directive for the Listing of Derivatives on the SWX Swiss Exchange” (the Directive), without explicitly using the notion of structured products, describes so-called “combined derivative products” as consisting of “a combination of different financial instruments – normally a bond with warrants or a conversion right”. The Directive then deals with various categories of combined products, including classical structured products

such as capital protected notes and reverse convertibles.

Delimitation from other products

In a dynamic market where new types of products are being created on an ongoing basis, in the absence of a clear legal definition, it is often difficult to determine whether certain investment products qualify as structured products (partially) subject to the CISA or not. Depending on the structure of a particular product, it can be delicate to determine if it is to be considered as a mere bond, subject only to the provisions of the Swiss Code of Obligations (CO) or as a structured product within the meaning of the CISA. Furthermore, when a product is linked with collective investment schemes, it is not always easy to determine whether the product could itself qualify as (or constitute indirect distribution of) a collective investment scheme. In such a case, the product would need to be authorized by the Swiss Federal Banking Commission (SFBC), which would in most instances defeat the purpose of issuing a structured product in the first place. The SFBC has addressed some of the delicate delimitation issues between collective investment schemes and structured products in its "Frequently Asked Questions" (FAQ) regarding structured products published on its website. Nevertheless, numerous delimitation questions remain unresolved at this time.

Under what conditions can structured products be offered in or from Switzerland?

Public offering

According to art. 5 CISA, structured products may only be offered publicly in or from Switzerland if they are issued, guaranteed or distributed by a Swiss bank, a Swiss regulated insurance company, a Swiss regulated securities dealer or a foreign institution subject to equivalent standards of supervision. Unless the relevant structured products are listed on a Swiss exchange, the foreign institution must have an establishment in Switzerland. Based on the practice of the SFBC, a representative office in Switzerland of the foreign institution is deemed to be

sufficient for this purpose. Accordingly, a fully fledged branch of the foreign institution in Switzerland is not necessary.

Furthermore, as a rule, a simplified prospectus must be issued and made available free of charge to the investor. No simplified prospectus is required, however, if (i) the product is listed on a Swiss exchange or (ii) if the product is not offered publicly in Switzerland but only from Switzerland, to the extent the relevant foreign regulations ensure transparency comparable to that of a simplified prospectus.

Non-compliance with these provisions can be sanctioned with a fine of up to 500,000 francs and may entail liability for damages incurred as a result thereof.

Since the above rules only apply to public offerings, it is important to clearly differentiate public offerings from private placement. It must be borne in mind that every offering is deemed to be public unless it fulfills the following so-called private-placement exceptions.

Private placement

An offering of structured products is not deemed to be public (private placement) and, as a result, the rules of art. 5 CISA do not apply, if the products are offered exclusively to qualified investors by means considered usual for this type of business (art. 3 CISO).

Prior to the entering into force of the CISA, private placement was also deemed to be at hand if only a narrowly defined circle of people (20 at the most) were contacted with respect to the offering. Since this "20 rule" is no longer applicable, it is not possible to contact any non-qualified investors without triggering the applicability of the rules regarding public offerings.

Qualified investors are defined in art. 10 para. 3 CISA and consist of regulated financial intermediaries (such as banks, securities dealers and fund management companies), regulated insurance companies, public entities and social security establishments with professional treasury, high net worth individuals (the threshold has been set at 2 million francs "financial investments"), as well as investors who have

entered into a discretionary asset management agreement with a regulated financial intermediary as described above. Furthermore, investors who have entered into a discretionary asset management agreement with an independent asset manager are also considered to be qualified investors, if they are subject to the Swiss money laundering legislation and to a recognized code of conduct (e.g. the "Code of Ethics and Professional Conduct of the Swiss Association of Asset Managers"). Finally the asset management agreement must comply with recognized standards of the industry (e.g. the "Swiss Bankers Association's Guidelines on Portfolio Management Agreements"). The SFBC Circular 03/1 on Public Solicitation (the Circular) provides in its revised version of August 29, 2007 that such independent asset managers themselves are also to be considered as qualified investors. Numerous further details pertaining to the interpretation of the various categories of qualified investors are to be found in the Circular.

The manner in which the qualified investors are contacted also plays a crucial role in determining whether private placement is at hand. Indeed, the qualified investors may only be contacted by means considered usual for this type of business. The Circular provides road shows and personal contacting as examples of such usual means. If inappropriate means are used, the offer is deemed public and the requirements of art. 5 CISA apply.

What documentation is required or usual for the issuance of structured products for the Swiss market?

Simplified prospectus

A simplified prospectus is required in the cases described above in the section regarding public offerings. According to art. 5 para. 2 CISA, the simplified prospectus must describe, in a standard format, the key characteristics of the structured product, its profit and loss prospects as well as the significant risks for investors. The simplified prospectus must be easily understood by the average investor. It must further indicate that the product is neither a collective investment scheme, nor re-

quires an authorization of the regulator. Art. 4 CISO foresees that the content of the simplified prospectus required for the public offering of (unlisted) structured products is to be determined by self-regulation of the industry. On this basis, the Swiss Bankers Association issued the Investor Information Guidelines which have been approved by the SFBC and entered into force on July 1, 2007. The Investor Information Guidelines contain a detailed list of the information which must be provided to the investors in the simplified prospectus.

In practice, for unlisted structured products, the simplified prospectus replaces the somewhat less comprehensive "term sheets" issued prior to the entering into force of the CISA.

Term sheets

Term sheets containing only a short summary of the terms and conditions continue to be used as the main marketing instrument for listed products. They are also used as a basis for obtaining provisional admission to listing on the SWX Swiss Exchange (SWX). Although the content of the term sheets is not regulated by law, it is nevertheless imperative to ensure that the investor is provided with accurate information and is not being misled, in particular with respect to the risks entailed by the relevant type of investment. It is usual to draw the attention of the investor at least on the specific product-related risks as well as on the issuer risk. Some issuers of both listed and unlisted products are now using the information required in the simplified prospectus also for the term sheets regarding unlisted products. It is likely that this trend will become more and more usual and, in the long term, become the norm.

Full prospectus/offering circular

Although the CISA explicitly provides that the prospectus requirement of art. 1156 of the Swiss Code of Obligations does not apply in the case in which a simplified prospectus is foreseen (issue of unlisted products), most issuers continue to prepare a "full prospectus" or "offering circular" containing more extensive information on the product

and much more complete terms and conditions. Both the simplified prospectus and the term sheets refer to the full prospectus and indicate how it can be obtained.

Listing prospectus/listing ad

In order to list structured products on the SWX, the issuers may proceed in one of three manners. Firstly, the issuer can provide the SWX with a complete listing prospectus for each individual issue. In such a case, the prospectus must in every instance contain all information foreseen in the SWX Listing Rules (the Listing Rules) with respect to the issuer, the security and the underlying instrument. Secondly, in order to simplify matters, it is possible to file the relevant information on the issuer ("basic documentation") once a year. If this possibility is made use of, only a short-form prospectus is required for each further issue within a period of twelve months. The listing prospectus then formally consists of the basic documentation and the short-form prospectus. Thirdly, the issuer can choose to prepare an "issuance programme" containing not only the information on the issuer but also generic terms and conditions applying to individual types of issues. When a programme is registered with the SWX, then only a "pricing supplement" containing the final specific terms and conditions needs to be prepared for each new product. When structured products are issued under a programme, then the listing prospectus formally consists of the programme and the pricing supplement. In all three cases, a listing notice must be published for each issue. For structured products, further to the general information pertaining to the listing and to the availability of the listing prospectus, the listing notice must provide information on the risks entailed by the relevant product.

Can structured products which comply with Swiss regulations be marketed from Switzerland to other countries?

Most product documentation includes selling restrictions into various other countries (as well as to U.S. citizens). The reason for this is that foreign leg-

islation may not allow or only allow the marketing of such products in the relevant country, if certain local requirements are complied with. For example, structured products may only be sold to investors in the European Economic Area, if a prospectus complying with the "EU Prospectus Directive" has been issued or on a private placement basis. In such a case, the relevant private placement rules of the foreign country (and not the Swiss ones described above) apply. The selling restrictions are intended to reduce the risk that breaches of foreign law take place.

Outlook

Despite the fact that structured products are only partially subject to the CISA, there are nevertheless many legal aspects which need to be considered when proceeding with an issue. Although until now litigation in Switzerland has remained minimal with respect to structured products, it is to be expected that the trend to file claims when losses are incurred by investors will increase in the coming years. Also, from a regulatory perspective, more and more criticism is being heard regarding the difference in treatment of collective investment schemes and structured products. It is indeed possible to offer very similar (if not identical) investment opportunities either in the form of strictly regulated collective investment schemes or in the form of basically freely conceived structured products. In the case of collective investment schemes, lengthy authorization procedures take place, and the assets are segregated for the benefit of the investors. Structured products presenting identical economic opportunities can, however, be issued without any authorization. This is possible despite the fact that, contrarily to an investment in a collective investment scheme, the investor bears the full credit risk of the issuer. Whether this differentiated treatment will be maintained much longer remains to be seen.

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