Private Equity

Third Edition

General Editors: Charles Martin and Simon Perry

Macfarlanes LLP

Private Equity provides a clear and comprehensive analysis of the key issues relating to private equity funds and deals in the key jurisdictions, providing an essential resource for legal counsel and investment professionals worldwide.

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SWEET & MAXWELL

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1. MARKET OVERVIEW

1.1 Types of investors

In line with the global trend, Switzerland continues to be attractive for private equity investments, although, in 2017, the investments in Swiss companies flattened.

The types of investors who invest in Swiss companies remain heterogeneous and include corporate and institutional investors, and increasingly family offices, entrepreneurial families and private individuals.

Domestic academic institutions, Federal and Cantonal governments (directly or through Cantonal banks) and Swiss pension funds remain comparatively marginal investors. This is due to a number of reasons, which include fragmentation of the market (with 26 Cantons primarily promoting, individually, their local businesses, and different regional innovation clusters being set up and sponsored locally) as well as regulatory limitations and constraints (such as the absence of a simple and suitable vehicle for private equity investments, as described further below). Despite recent relaxation of regulatory limitations, pension funds remain reluctant towards private equity investments—an attitude which is understandable, given the solidity of other investment categories, such as the local real estate market and Swiss "blue chip" listed companies. Within private equity, in Switzerland, there are substantial differences with regard to the most common sources of funding in the different market segments (venture capital (VC), growth and buyout).

Finally, capital is increasingly raised through initial coin offerings (ICOs), although, just like crowd lending, this is not really relevant in the context of private equity.

1.2 Types of investments

Switzerland has a strong start-up and VC industry with an increased involvement in the high-tech sector. In 2017, new record levels were achieved in the overall investment and the number of financings rounds according to the *Swiss Venture Capital Report* (2018) (available at: *https://www.startupticker.ch/uploads/File/Attachments/VC%20Report%202018_WEB_v.pdf* [Accessed 19 September 2018]). Biotech and ICT were growth drivers. The invested capital rose from approximately CHF 300 million in 2012 to CHF 938 million in 2017, although, compared to 2016, it has flattened.

Indeed, traditional VC financings have suffered in the last 18 months since the emergence of ICOs. Not only start-up companies but also later-stage ventures, including those active in non-blockchain related industries, such as biotech companies, have been entering the ICO market to seek additional

funding, sometimes even after having completed initial VC rounds. The attraction for the existing shareholders in such ICO companies obviously is the ability to find funding in ICOs without diluting their equity stakes. The crowdfunding element attached to ICOs allows for significant capital raising through large numbers of investors, in most cases, investing significantly less than EUR 1,000 each. VCs have meanwhile also complained that some good investment opportunities have moved into the ICO sphere. Having said that, there has been a cooling off in the success rate ICOs have had during the last quarter. We believe that ICOs will move towards offering more interesting economic rewards than has been the case in the past. We likewise believe that VCs will consider investing into ICOs on a broader basis than this happened in the past as the ICO market matures. Proof of this is the fact that the significance of fiat currencies raised in token sales is increasing compared to the sales proceeds raised in cryptocurrencies, in particular, in the private and pre-sale phases.

There is a very broad and heterogeneous spectrum of transactions, ranging from seed to start-up and later-stage ventures. Public to private transactions remain less common, although a few players specialise in this segment. Minority investments in public companies are rather unusual in Switzerland, while the last few years have seen a number of transactions going public by way of reverse merger with listed companies.

2. FUNDS

2.1 Fund structures

Swiss fund structures and fundraising in or from Switzerland are governed by the Federal Act on Collective Investment Schemes of 23 June 2006 (CISA) and the Federal Ordinance on Collective Investment Schemes of 22 November 2006 (CISO).

The CISA distinguishes between: (1) open-ended structures (contractual investment funds and investment companies with variable share capital (*société à capital variable* or SICAV)), where investors have the right to redeem their shares at net asset value; and (2) closed-ended structures (limited partnership and investment companies with fixed capital (*société à capital fixe* or SICAF)), where redemption rights are limited or not available at all (distributions are only made upon divestments of the portfolio or final dissolution).

By the nature of their investments (illiquid mid to long-term investments), private equity funds are typically set up as closed-ended structures. The two closed-ended structures available under the CISA are: (1) the limited partnership for collective investment (LPCI); and (2) the SICAF.

The Swiss limited partnership for collective investments

An LPCI must invest in ““risk capital” and has been specifically created for alternative investments, private equity, real estate or infrastructure projects. It can invest either directly or through other investment structures. The CISO defines “risk capital” as the capital used for direct or indirect financing of companies and projects which offer the possibility of generating above average returns with above average risks. Investments may be made out of the LPCI’s equity, third-party financing or by a mixed form of financing, such as mezzanine financing. Pursuant to the CISO, LPCIs are permitted to invest in

two other types of assets, namely: (1) real estate, constructions and infrastructure projects; and (2) alternative investments. To fulfil their purpose, LPCIs may take control of companies and place representatives on the board of its portfolio companies in order to further the interests of their investments.

The structure of the LPCI is similar to the typical limited partnership organised under the laws of Anglo-Saxon jurisdictions: (1) its sole purpose must be collective investment; and (2) its members shall consist of: (a) at least one general partner who is subject to unlimited liability; and (b) limited partners who are only liable up to a set amount (the limited partners' contribution).

The general partner must be a Swiss company (*société anonyme/ Aktiengesellschaft*) with a minimum paid-in share capital of CHF 100,000 and which may only act as general partner for one LPCI.

LPCIs must obtain a licence from the Swiss Financial Market Supervisory Authority (FINMA) prior to any activity and is subject to FINMA's ongoing supervision. The general partners must also fulfil the general authorisation requirements under the CISA, which include in particular the following:

(1) all persons responsible for the management and the business operations of the general partner must: (a) have a good reputation; (b) guarantee proper management; and (c) possess the required professional experience;
(2) all significant equity holders of the general partner must have a good reputation and not exert their influence to the detriment of prudent and sound business practice;
(3) it must have in place internal regulations and appropriate organisational structure; and
(4) it must have sufficient financial guarantees.

All limited partners must be Qualified Investors within the meaning of the CISA. The circle of Qualified Investors includes, among others, institutional investors and certain high-net-worth individuals (see definition of "Qualified Investors" below).

An LPCI may only manage its own investments and is prohibited from providing management services to third parties or carrying out a commercial activity. It must appoint a custodian bank and a paying agent in Switzerland. In addition to the CISA and its ordinances of application, the LPCI is also governed by the provisions of the Swiss Code of Obligations relating to limited partnerships in general.

The limited partnership's agreement and the prospectus of the LPCI must contain information regarding the investments, investment policy, investment restrictions, risk diversification, risk associated with investments and investment techniques used by the LPCI.

The general partner of the LPCI may delegate the investment decisions of the partnership to a third party, provided that it is in the interests of an efficient management of the LPCI and further provided that such delegation is made to persons sufficiently qualified to carry out such tasks. In any event, the general partner remains responsible for instructing and monitoring the persons to whom duties have been delegated and for controlling the due performance of such duties.

The relationship between the general partner(s) and the limited partners is governed by a partnership agreement, which generally benefits from contractual freedom subject to certain mandatory provisions. Partnership agreements typically include provisions on the following matters:
(1) capital commitment and possible extension;
(2) repayment of capital;
(3) duration of the LPCI and possible extension;
(4) management and representation of the LPCI;
(5) management fees;
(6) investment policy, investment restrictions, risk diversifications, investment techniques;
(7) reporting, right to receive information;
(8) conditions for admission of new and withdrawal of existing investors, and transfer of participations;
(9) participation rights and voting rights of the limited partners; and
(10) distribution of income.

LPCIs must in addition issue a prospectus. The Swiss Funds and Asset Management Association and the Swiss Private Equity and Corporate Finance Association have published a template prospectus, which has been acknowledged by FINMA for the purpose of licensing proceedings.

Until now, notwithstanding the efforts of the Swiss legislator to create a new type of vehicle to accommodate private equity investments, the success of LPCIs as structures to set up Swiss private equity funds has been limited. Indeed, as of June 2018, only 18 LPCIs have been registered with FINMA. They have essentially the purpose to invest in real estate and infrastructure projects, medicine and life science or have been set for VC.

The SICAF

The SICAF is the second closed-ended structure available under the CISA that could be used to set up a private equity fund. In short, a SICAF is an investment company with fixed capital: (1) which takes the form of a Swiss company (*société anonyme/Aktiengesellschaft*); (2) whose sole purpose is collective investment; (3) whose shareholders do not need to be Qualified Investors; and (4) which is not listed on a Swiss stock exchange. Swiss companies whose shareholders are exclusively Qualified Investors or whose shares are listed on a Swiss stock exchange are not subject to the CISA and therefore may not qualify as a SICAF.

Like the LPCI, in addition to the CISA, SICAFs are governed by the provisions of the Swiss Code of Obligations relating to companies.

SICAFs must have a custodian bank and a paying agent in Switzerland. Their articles of association and internal regulations must contain rules regarding the investments, the investment policy, the investment restrictions, risk diversification and the risks associated with investments.

Due to, among other things, the applicable tax regime (see below), since the entry into force of the CISA, not one single SICAF has been registered as a private equity structure.

Conclusions

With the exception of a few private equity LPCIs, currently, the vast majority of private equity funds active in Switzerland are set up outside Switzerland, mainly as offshore funds. Switzerland remains, however, an important market for fundraising. Therefore, the regulation on fundraising plays an important role for private equity funds.

2.2 Regulation of fundraising and fund managers

Fundraising

The Swiss legal framework of fundraising is based on the concept of "distribution". If an activity is deemed a distribution in or from Switzerland, it falls within the scope of and is subject to the requirements of the CISA, unless the CISA provides an exemption. "Distribution" is defined as any offer or advertisement for funds in view of obtaining subscriptions, which is not exclusively directed at "Regulated Qualified Investors" (see definition below). It encompasses any proposal or marketing aiming at the acquisition/ subscription of any fund regardless of the means.

Distribution of foreign funds to non-qualified investors requires a prior authorisation from FINMA. Private equity funds are typically not directed at retail investors. Due to their characteristics (in particular their investment policy, closed-ended structure, low diversification and absence of domestic supervision recognised as equivalent to that required in Switzerland), none of the offshore funds could obtain authorisation by FINMA for distribution to non-qualified investors.

As a result, the raising of capital by private equity funds may only be made in or from Switzerland under exemptions provided by the CISA or to Qualified Investors.

The following activities are not deemed distribution and do not fall within the scope of the CISA:

(1) the distribution of foreign funds to regulated financial intermediaries subject to the supervision of FINMA such as banks, securities dealers, fund management companies, regulated asset managers of collective investment schemes and central banks ("Regulated Financial Intermediaries") and regulated insurance institutions (together with Regulated Financial Intermediaries, "Regulated Qualified Investors");
(2) the provision of information and the offer of funds at the instigation or request of the investor (reverse solicitation);
(3) the provision of information and the offer of funds to investors under a written asset management agreement entered into with a Regulated Financial Intermediary;
(4) the provision of information and the offer of funds to investors under a written advisory agreement entered into with a Regulated Financial Intermediary (provided that the written advisory agreement contemplates an advisory relationship for a financial consideration and is entered into on a long-term basis); and
(5) the distribution of funds under certain employee participation plans.

Distribution directed at "Unregulated Qualified Investors" falls within the scope of the CISA and triggers certain obligations regarding the funds and the distributors.

The following categories of investors are considered "Unregulated Qualified Investors":

(1) public entities and pension funds with professional treasury operations;
(2) companies with professional treasury operations;
(3) certain high net worth individuals within the meaning of the CISA and the CISO (generally with assets of at least CHF 5 million or, alternatively, financial assets of at least CHF 500,000 and market knowledge based on individual education and professional experience or similar experience to assess the risks of the investment) may request in writing to be treated as qualified investors; and
(4) investors that have entered into a written asset management agreement with a Regulated Financial Intermediary or a recognised independent asset manager pursuant to art.3(2)(c) of the CISA and have not declared that they want to be treated as non-qualified investors ("opt-out"), provided that the Regulated Financial Intermediary or the recognised independent asset manager is involved in the distribution from the outset.

"Qualified Investors" refer to both regulated Qualified Investors and Unqualified Investors.

In case of distribution to Qualified Investors, foreign funds are not required to obtain an authorisation from FINMA but they are subject to certain requirements, which include in particular:

(1) the appointment of a Swiss representative and a Swiss paying agent prior to any distribution activity in Switzerland;
(2) the name of the foreign fund must not be confusing or misleading; and
(3) the documentation of the foreign funds must be adapted to include Swiss specific disclosure and information.

Swiss and foreign financial intermediaries who contemplate distributing foreign funds to Qualified Investors must be subject to an appropriate supervision (i.e. Swiss financial intermediaries must be authorised as distributors by FINMA or benefit from an exemption based on their regulatory status and foreign financial intermediaries, who distribute on a cross-border basis, must be authorised to distribute funds in their home jurisdiction and be appropriately supervised).

They are subject to further requirements, which include in particular:

(1) they must enter into a distribution agreement subject to Swiss law with the Swiss representative(s) of the fund(s) which they distribute;
(2) they use fund documentation which comply with the requirements of Swiss law and in particular which indicates the details of the Swiss representative and the paying agent, the jurisdiction of origin of the fund, the place of jurisdiction/performance and the place where the fund documents can be obtained free of charge (i.e. the Swiss representative), as well as certain information and disclosure on fees and costs, retrocessions and rebates pursuant to the Guidelines on Duties Regarding the Charging and Use of Fees and Costs of 22 May 2014 issued by the Swiss Funds and Asset Management Association; and
(3) they comply with Swiss regulations on distribution of collective

investment schemes.

Operations of private equity funds

Under the CISA, "fund management companies" (responsible for the overall management and administration of a collective investment scheme) are treated differently from "asset managers" of collective investment schemes (which are only responsible for managing the assets and/or the risks of funds). Under the CISA, any entity responsible for the management of collective investment schemes, or the safe keeping of the assets of collective investment schemes, must obtain an authorisation from FINMA. "Fund management companies" may delegate the asset management and/or risk management activities to a third party. Swiss asset managers of Swiss and non-Swiss collective investment schemes must also obtain an authorisation from FINMA, except if investors of the fund(s) which it manages are Qualified Investors and: (1) the assets under management, including the assets acquired through the use of leveraged finance, do not exceed CHF 100 million; or (2) the assets under management do not exceed CHF 500 million and consist in non-leveraged collective investment schemes where investors are not permitted to exercise redemption rights for a period of five years from the date of their first investment.

2.3 Customary or common terms of funds

With regard to terms of a Swiss LPCI, please see the corresponding sub-section of s.2.1 above.

3. DEBT FINANCE

3.1 Means of financing

Companies can issue bonds which, if the offer is to a limited circle of individuals only, will be deemed a private offer. As a rule of thumb, an offer to more than 20 individuals is considered to be public if it is offered to investors that are not selected and approached on an individual basis. It has to be noted that even an offering made to all customers of a bank is a public offering as the investors contacted are not individually chosen.

Whilst the market for domestic and international bonds in Switzerland is on the lower side given the low interest rates, there seems to be an appetite by investors for C-Graded Bonds.

The other form of financing combining debt and equity is mezzanine financing, where debt and participation rights of the lenders can be relatively freely agreed upon. Depending on the terms, this will result in the debt financing being considered as equity from a corporate law point of view. Finally, capital is increasingly raised through crowd lending, although this is not really relevant in the context of private equity.

3.2 Restrictions on granting security

There are certain restrictions in Swiss corporate law on Swiss companies granting a benefit to group companies other than their own subsidiaries. In finance transactions, these upstream benefits could typically arise if a Swiss company grants a security interest to a lender to secure obligations of its parent or other group company. Guarantees and other security interests

granted by a Swiss subsidiary or other group companies may therefore require different actions to be taken, such as:

- making sure that the transaction is covered by the company purpose and, if not, amending the articles of association to include the right to grant upstream and cross-stream loans, guaranties, security and other benefits;
- reminding the directors that they must at all times act in the best interests of the company. There is no concept of interest of a group of companies under Swiss corporate law and, hence, companies must enter into transactions that are in their own interests rather than in any "group interest". Granting security for the benefit of a parent company and/or other group companies could be null and void if such a security is not given at arm's length or would result in the disposal of essential operating assets of the Swiss subsidiary or obviously exceeds its economic capacity; and
- inserting a specific limitation language in the facility agreement or each security agreement. Such language is required as a security granted by a Swiss subsidiary to secure obligations of a parent and/or group company may be considered as a redemption of equity contribution, distribution of legally protected reserves or constructive dividend and could violate withdrawal regulations under Swiss corporate law.

Given these withdrawal restrictions, transaction agreements usually provide that any payment by the Swiss company shall be limited to its free reserves and profits available for distribution to shareholders at the time of the enforcement of such a security. The mechanics for payment require the Swiss company to arrange for an audited interim balance sheet and resolutions of the board of directors and shareholders to make an amount available for payment from the free reserves available for distribution.

Even in the event that there is no prohibited return of equity as set out above, the security granted could represent a hidden distribution of dividends. A benefit granted in favour of a parent group company qualifies as a hidden distribution of dividends if—according to the standard of "dealing at arm's length"—there is a manifest disproportion in the consideration which is to the detriment of the Swiss subsidiary. A hidden distribution of dividends may trigger withholding tax at the current rate of 35% (subject to any applicable double tax treaty), whereby there is an additional risk of the tax being "grossed-up" (i.e. the distributed sum is considered to be merely 65% of the dividend).

According to case law, in the context of cash pooling, an up or cross-stream loan blocks the freely disposable equity of a company as a result of which dividends can only be paid out to the extent that there is an excess of disposable equity.

3.3 Intercreditor issues

Syndicated lenders are all treated as pari passu creditors of a Swiss company in bankruptcy or debt moratorium provided that they have a direct claim against the latter. Sub-participants are not able to exercise direct claims against the Swiss company and there is no possibility under Swiss insolvency law for lenders to split the claim and/or the vote with their sub-participants. The only

way for the sub-participant to exercise any right in bankruptcy or debt moratorium proceedings is to agree with the lender to transfer the debt by way of assignment.

3.4 Syndication

Loans can be syndicated before or after the transaction is completed. If before, syndicated loan agreements governed by English law usually provide for a security agent or security trustee acting as agent or trustee for all the lenders. For Swiss law governed security, security agents and security trustees typically act as agents of the finance parties. Should the loan be syndicated after the deal is done, it triggers the following issue with respect to security arrangements governed by Swiss law: some security interests (e.g. pledges) created under Swiss law are considered as a collateral security (*akzessorische Sicherheit*) conditional upon the existence of a valid claim. Such a security has the priority provided for under the agreements as long as the secured obligations have not been invalidated, discharged, novated, waived or otherwise expired, lapsed or terminated. If the syndicated loan agreement allows a lender to transfer its claims by way of novation, there is a risk that the security would lapse automatically with the transfer (by novation). Parallel debt wording is therefore typically inserted into the facility agreements with the aim of mitigating or eliminating this risk but the concept of a parallel debt has never been decided on by a Swiss court. There is, theoretically, a remote risk that the parallel debt provision could be attacked on the grounds of so-called simulation.

Syndication may also trigger tax issues to be considered in all syndicated transactions, including those allowing sub-participations. In principle, if there are more than 10 so-called non-bank lenders participating in the facility by way of assignment, transfer, novation or sub-participation or, if the Swiss company has more than 20 non-bank creditors, interest payments become subject to withholding tax at the current rate of 35%. For the purpose of the threshold of non-bank creditors, private placements ("club-deals") are counted as one per formal written instrument of debt acknowledgement (tranche) and, under certain circumstances, where the refinancing of a bank is such that the bank appears to be only interposed and not acting in its own economic interests, the lenders to that bank would also count for the threshold of non-banks.

4. EQUITY STRUCTURES

4.1 Role of management

Management is key to the success of a company and, as such, it is usually also key to a private equity investment and its development. In this respect, Switzerland provides a favourable legal framework and cultural environment for management to thrive. Indeed, the flexibility of the Swiss legislation in the areas of labour and contracts laws, as well as its comparatively low personal taxation level, provides an auspicious environment for the management team to be adequately incentivised.

The role of management that is typically experienced in Switzerland is the following: the management—and in particular the Chief Executive Officer (CEO)—will, generally, sit on the board of directors. Other members of top

management, such as the Chief Fnancial Officer (CFO) or the Chief Operational Officer (COO), are also sometimes offered board membership, although in practice this is less common.

Employment agreements

In employment agreements for the management, a common feature is the insertion of incentives for the achievement of certain goals (in the form of variable salaries, cash bonus payments and/or participation plans) in order to strengthen long-term involvement of the management in the cause of business. Such employment agreements often also provide for incentives and may also include other provisions, which are usually considered important from an investor's perspective, such as: (1) non-competition obligations (limited by statute as to scope and duration) and non-solicitation undertakings; (2) assignment of intellectual property; as well as (3) minimum terms of employment or long notice periods (in particular for key management, an initial term of one to two years and/or notice periods of six months to one year are not unusual).

In addition, Swiss law allows an ample degree of flexibility in terminating an employment agreement. Except in special circumstances, employment agreements can be terminated within the contractually agreed notice period and without any indemnification or additional payment. Moreover, it is generally possible to send an employee on garden leave during the notice period.

Participation of management

It is usual for management to be offered a participation in the company up to a certain minority percentage (usually around 3–5%, although the percentage may vary, e.g. be somewhat higher—and the salary lower—in start-up and early-stage companies). Such participation is often structured by way of grants of shares and/or share options (which entitles the holder of shares to both economic benefits and voting rights), and sometimes as profit participation certificates (which usually give only economic benefits). Management participation is usually achieved through company shares/share option plans, sometimes also by means of individual share purchase agreements or—much less frequently—of indirect participation rights (i.e. participation in a special purpose vehicle which holds shares or other participation rights in the company).

Phantom shares (i.e. the allocation of a merely virtual share in the company which is not incorporated in any security or title) are quite unusual. Share option plans typically contain deferred grants and vesting periods (sometimes of several years—it is usual for a company at growth stage to have a vesting period of between one and three years while, for companies at a start-up stage, the vesting period can be much longer) in order to secure managemen"s long-term involvement. The exercise of options is very often determined by adherence to a shareholders' agreement imposing limitations on voting rights and restricting the disposal of shares; continued employment is also a common condition for the exercise of good leaver and bad leaver provisions.

Cliff vesting is often provided in the event of a trade sale, an initial public

offering (IPO) or the achievement of certain milestones.

4.2 Common protections for investors

Investment agreements

Investment agreements typically contain initial investment protection, in particular with regard to representations and warranties given by companies and/or management. Since a company"s representations and warranties coupled with monetary indemnification may violate the legal prohibition on redemption of capital contributions, investment protection towards companies must be structured accordingly, e.g. through compensatory capital increases or similar provisions of indirect indemnity.

Shareholders' agreement

The basic and long-term protection of investors and their investments are implemented through a shareholders' agreement, which will usually include a number of provisions ensuring that any new shareholder will adhere to and fall within its scope of application. To some extent, the provisions of a shareholders' agreement can be further strengthened in the company's articles of association and in regulations of the board of directors. Common investment protection instruments include: (1) the issue of preferred shares; (2) anti-dilution provisions; and (3) transfer restrictions in the form of rights of first refusal and pre-emption rights. Shareholders' agreements also often contain call options exercisable against a party in breach of contractual obligations. Statutory subscription rights under Swiss company law, coupled with the fact that all share capital increases must be resolved or authorised by the shareholders, also provide anti-dilution protection as well as protection for minority shareholders, or control over future share capital issuances. Quorum requirements at the level of shareholders and voting obligations are also common protection instruments.

Directors and information rights

In addition to those mentioned above, other investment protection tools include the right for sizeable investors to appoint their own representatives on the board of directors, or at least observers, as well as provisions regarding composition of the board of directors. It is also usual to include reporting requirements and information rights (on financial and other issues) and direct supervision over management. It is worth mentioning that directorship can sometimes be a double-edged sword for investor representatives, especially in early-stage companies or in restructuring and turn-around situations, since the members of the board of directors have an obligation to act solely in the interest of the company, while failure to do so may trigger personal liability.

Rights to exit

Investors typically secure a successful exit strategy (IPO, trade sale etc) by means of strong drag-along clauses. The deposit of issued share certificates with an escrow agent, who is provided with corresponding instructions, may further secure the investors' right and the possibility to effect exit transactions in a short timeframe, especially against inactive or opposing minority shareholders.

4.3 Common protections for management

Protection of minority rights

Management members do not always have board seats and, if they do, they usually do not enjoy any veto rights. Nevertheless, minority rights of management and/or their position may be protected through appropriate provisions in a shareholders' agreement but outright veto rights are unusual rather than qualified majority selected matters. Pursuant to Swiss company law, statutory subscription rights for shareholders in capital increases grant a certain degree of anti-dilution protection to minority shareholders (although it is not rare that these rights are waived in shareholders' agreements). Usually, management's position is further secured through tag-along rights and sometimes through obligations of investors to allocate a certain percentage of the capital to management and/or key employees (a pool of 12–15% is common for start-up and early-stage companies, while this percentage is usually lower for growth-stage companies).

Termination of employment

Share option plans and shareholders' agreements often provide for favourable conditions if employment is terminated for convenience by the company (e.g. good leavers clause in case of a change of control). Inversely, the termination of a manager's employment may lead to a right for other investors to purchase their shares by means of pre-agreed price mechanism.

4.4 Management warranties

The fund normally expects the management to give far-reaching warranties. The warranties cover in particular those aspects of which the management has better knowledge than the shareholders and the board of directors.

Typical warranties

The warranties that are solicited usually cover the target company's financials and current and future business, including the plans and the circumstances that may lead to future risks. In particular, the management will typically guarantee: (1) the correctness and the completeness of the due diligence; (2) the absence of adverse changes for the time period ranging from the last audited financial accounts to the closing; (3) the availability of the intellectual property rights, permits and authorisations necessary to carry on the target company's business; (4) the absence of claims, actions, investigations or proceedings pending or threatened; and (5) compliance with applicable laws, tax and social security obligations and pension plan requirements.

Time-limit and caps

Usually, warranties contain both a time-limit and a cap. The time-limit usually depends on the business field of the target company, i.e. how easily risks can be discovered after the target company's acquisition. As a general rule, one might expect an average warranty period of 12 months. While the warranties pursue the objective of obtaining full disclosure by the management, the liability cap achieves a counterbalance effect to the extent it limits the financial risks for the members of the management. Usually, the liability cap amounts approximately to annual one-year compensation of the

respective individual. Consequently, the managers of a company might each be eligible for different warranty caps. Additionally, there is a minimal threshold under which no claim shall be raised. Such threshold amounts in general to one-sixth of the annual compensation of the respective individual.

4.5 Good leaver/bad leaver provisions

Bad leavers

If a member of the management leaves the target company as a bad leaver, the other shareholders will typically be entitled to exercise a call option within a timeframe of at least one month to purchase the shares of the bad leaver in proportion to their respective participations in the target company. If some shareholders renounce their call option rights, the others will be entitled to purchase additional shares. The price of the shares amounts to either: (1) the market value; or (2) the lower of the market value and the price which the member of the management paid for the shares.

Good leavers

A good leaver might be either: (1) entitled to keep its shares, usually while continuing to be bound by the shareholders' agreement; or (2) required to sell them in case the other shareholders desire to exercise their call options. However, in this case, the price for the shares generally amounts to either: (1) the market value increased by a premium; or (2) the higher of the market value and the price which the member of the management paid for the shares.

The calculation of the market value is also defined in the shareholders' agreement. Where there is disagreement among the parties, the market value will typically be finally established by an appraiser. The procedure for the appointment of the appraiser and the party that bears the appraisal costs are usually regulated in the shareholders' agreement as well.

4.6 Public to private transactions

It is not common in Switzerland for a private equity fund to make offers for public companies.

5. EXITS

The nature of private equity investments is that they are pursued for a limited period of time, usually between two and seven years, with a maximum of up to ten years. The primary motivation being financial, their main goals can be distilled down to two basic points: obtaining the highest possible profit from their investment and a successful exit. This means that private equity investors will only invest if they are confident that there are several different options available to them to achieve a successful exit. Despite its relatively small size and number of players, the Swiss market offers good exit options and is comparatively liquid", as has been demonstrated in recent years by the partially substantial and successful exits of private equity investors, notably in the areas of life sciences, biotech and pharmaceuticals.

Exit options available to investors in the Swiss market are: secondary sales (s.5.1 below); trade sales (s.5.2 below); IPOs (s.5.3 below); refinancings (s.5.4 below); and restructuring or liquidation (s.5.5 below).

5.1 Secondary sales

The buyer in a secondary sale is generally another private equity investor. Though it is true that sophisticated players tend to prefer lengthier agreements which compare with international standards, sale and purchase agreements with respect to stockholdings in Switzerland can be drafted in a few pages and indeed this is usually practice. Swiss statutory provisions foresee very short notice periods to claim a misrepresentation or breach of warranty. Sale and purchase agreements therefore make stipulations to exclude the application of such statutory provisions.

In addition, Swiss law provides very limited protection with respect to damages incurred within the target company. Consequently, sale and purchase agreements must expressly foresee rules according to which the buyer can recover the damage incurred by the target company.

A final important point is that statutory representations and warranties imposed under Swiss law where there is a sale of shares of an undertaking are very limited. Accordingly, it is standard practice for the buyer to request that all representations and warranties which are customary and appropriate for the individual sale transaction be listed in the sale and purchase agreement.

5.2 Trade sales

In Switzerland, this exit option is often the most attractive one for investors since it gives them the opportunity to sell all their stock in a transaction, without being limited by the kind of lock-up provisions otherwise present in an IPO (see s.5.3 below), while being able to take advantage of any contractual exit preference such as partial exit possibly with earn out provision. Furthermore, from a tax perspective, this exit route may result in a tax-free capital gain for corporate and individual investors.

Drag-along/tag-along provisions

To secure this exit option, the equity investor should set out drag along/tag along provisions in the investment agreement or shareholders' agreement which will compel/enable other shareholders to sell their shares along with the investor. Such provisions, which are acceptable and in principle enforceable under Swiss law, significantly increase the liquidity of the investment. It is also important for the investor to provide for a right of first offer, which will allow them to control the entry of future shareholders and to secure a possible trade sale.

Exit preference

Parties can also set forth in the agreement that the investor shall have a preferred position with respect to the proceedings of a trade sale ("exit preference"). This rule cannot be included in the articles of association of Swiss companies but can be inserted into shareholders' agreements. Swiss law allows for some leeway in the drafting of such provisions. Hence, legal engineering is available where sophisticated parties require it.

5.3 Initial public offerings

In Switzerland, a listing is possible at the SIX in Zurich or at the Berne eXchange (BX) in Berne.

A listing may be an exit option of interest to an investor since it increases the liquidity—and thus the price—of the securities' trades and simultaneously enhances the reputation of a company. Obvious as the advantages may be, it is nevertheless worth mentioning that a listing is a very long process (about six months) and that it is expensive, both in terms of management time and of legal and financial advisers' fees.

In this context, a relevant development is that, since 1 January 2014, listed companies must organise a mandatory and binding shareholders' vote on the aggregate compensation allocated to the board of directors and to the senior management each year, including the payment of golden parachutes and signing-on bonuses for the governing bodies of the company.

An IPO will also often compel the company to change its equity structure. Where private equity investors hold preferred shares, as is often the case in Switzerland, these rights must then be adapted for an IPO. With this in mind, it is advisable to draft in the investment agreement a provision according to which the preferred shares shall be converted into ordinary shares if and when the shares were to be listed so that this hurdle may be avoided.

One of the main inconveniences of an IPO for the investor is that a quick and complete exit is seldom possible given the prevalence of investment agreements concluded in Switzerland which impose lock-up obligations on investors. The most common formulation of such an obligation prevents the investor from selling its shares during a period of six months. For young companies, this kind of prohibitions can also be mandatory as per the directives of the SIX. Another issue with IPOs is that new shares are often issued. Under Swiss corporate law, existing shareholders are protected from capital dilution in the case of a share capital increase. However, these protective rights of shareholders can be limited or withdrawn if it is justified by a fair reason and if all shareholders are treated equally. In addition, shareholders' agreements often contain the possibility for dilutions.

Under Swiss law, unless the articles of association of a company give power to the shareholders' meeting or the organisational regulations give power to the management, the decision to list a company does not lie with the shareholders but rather with the board of directors. In the event that the shareholders do have the right to decide on this item, a majority vote is then required. To secure this exit route, a minority investor could negotiate a contractual right to decide by itself on a resolution with regard to the listing.

As for the issue of price setting—for instance, through a book-building process—it is important for the investor that has not secured a majority of board seats to have set out in the shareholders' agreement that the decision on price requires its agreement, such a rule being admissible under Swiss law.

5.4 Refinancings

Refinancing or recapitalisation allows a change of the capital structure of a company through the substitution of debt for equity. When this process is initiated by the company itself, it is called a leveraged recapitalisation. For the investor, a leveraged recapitalisation is not a real exit option since it remains shareholder of the company but such a process can instead be considered the preamble to a subsequent exit.

It is worth mentioning that under Swiss law, the articles of association can provide that holders of preferred shares—which need not be in the form of registered shares—may benefit from a priority or higher dividend than common shareholders.

5.5 Restructuring/insolvency

The insolvency option is often the least appealing option for a private equity investor since the assets of the company will be sold at their liquidation value, which is generally substantially less than the continuation value. However, in some cases, liquidation may be a good means for the investor to redeem the capital and the reserves since, in this situation, Swiss law does not set out any particular rules for the protection of capital. The threat of liquidation can also prove a useful negotiation tool for the investor to convince the management to find a buyer for the company.

Where the investor does not hold a majority of the share capital but wishes to trigger the liquidation process, a duty should be negotiated in the shareholders' agreement for the other shareholders to vote for the liquidation in certain circumstances.

As a final note, the articles of association of Swiss companies can provide holders of preferred shares with an advantage on the liquidation proceeds.

6. TAX

6.1 Taxation of fund structures

Swiss income and capital taxes

Contractual investment funds (FCPs), SICAVs and LPCIs that were approved by the Swiss supervisory authority in accordance with the CISA are not treated as taxpayers for Swiss income and capital tax purposes. In this respect, these collective investment schemes are transparent. Income from units of these collective investment schemes is fiscally attributed on a pro rata basis to the unit holders irrespective of whether the income is distributed (*Ausschüttungsfonds*) or accumulated (*Thesaurierungsfonds*). The Swiss resident unit holder is subject to Swiss income tax on dividends, interest etc realised by these collective investment schemes. Swiss income tax arises at the moment the distributed income becomes due (*Ausschüttungsfonds*) or the accumulated income is credited, i.e. at the moment of debiting in the account of reinvestment (*Thesaurierungsfonds*).

Capital gains upon the sale or redemption of units in these collective investment schemes are income tax-free in the hands of the Swiss resident individual unit holder if he or she holds the unit as private assets (i.e. the unit is not related to a business activity). The redemption of units is taxable insofar as the liquidation proceeds include income that has not yet been taxed in the hands of a Swiss resident individual unit holder.

The LPCI is a limited partnership. The Swiss resident unit holders (limited partners) of an LPCI are subject to Swiss income and wealth taxes on the income and the assets of the LPCI. As capital gains derived from movable assets that are held as private assets and do not relate to a business activity are income tax-free, capital gains realised by the LPCI are not taxed in the hands of the Swiss resident individual unit holders. The holding of units of a LPCI as limited partner does not itself qualify as a business activity of the Swiss

resident individual unit holder.

As an exemption, FCPs, SICAVs and LPCIs are treated as taxpayers for Swiss income and capital tax purposes to the extent they own Swiss or foreign real estate, irrespective of whether the income is distributed (*Ausschüttungsfonds*) or acccumulated (*Thesaurierungsfonds*). These collective investment schemes are subject to a particular (lower) corporate income tax rate. Income from Swiss and foreign real estate is exempted at the level of the Swiss resident unit holder as this income is subject to Swiss corporate income tax at the level of the FCP, SICAV and LPCI.

In contrast, SICAFs are always treated as taxpayers for Swiss income and capital tax purposes, irrespective of whether they own Swiss or foreign real estate. The unit holder realises dividend income upon distribution that is subject to Swiss income taxes. Capital gains realised by SICAFs are converted into taxable income in the hands of a Swiss resident individual unit holder. A SICAF is entitled to participation relief on dividend and capital gains derived from qualifying participations.

The reason for the different Swiss tax treatment between SICAVs and SICAFs is the right of the SICAV unit holder to redeem units at their net asset value. This right brings the legal relationship of a SICAV economically into the scheme of a FCP that is treated as transparent.

A Swiss resident individual unit holder is not entitled to shareholder relief on dividends from qualifying participation in SICAFs. Capital gains upon the sale of units in a SICAF are income tax-free in the hands of the Swiss resident individual unit holder if he or she holds the unit as private assets (i.e. the unit is not related to a business activity). A Swiss resident corporate unit holder is entitled to participation relief on capital gains and dividends from qualifying participations in SICAFs.

In the hands of a Swiss resident individual unit holder, the redemption of units is taxable in so far as the liquidation proceeds exceed the nominal value and the paid-in capital of the participation.

Due to the economic double taxation of corporate profits (taxation of corporation profits and taxation of distributed dividends) in Swiss taxation and the conversion of capital gains realised by SICAFs into taxable income in the hands of a Swiss resident individual unit holder, SICAFs were not previously attractive as collective investment schemes. However, due to the lowering of the corporate income tax rates in the past, the disadvantage of non-transparency has been significantly reduced. Further, as capital gains upon the sale of units in a SICAF are income tax-free in the hands of the Swiss resident individual unit holder if he or she holds the unit as private assets (i.e. the unit is not related to a business activity), a cumulating SICAF (*Thesaurierungsfonds*) may provide tax advantages. However, the Swiss withholding tax (Swiss WHT) on dividends paid by the SICAF is a significant obstacle for non-Swiss resident investors.

Foreign withholding taxes

FCPs, SICAVs and LPCIs are not treated as Swiss resident persons for treaty purposes. Therefore, these collective investment funds are not entitled to relief from foreign withholding taxes under an applicable double tax treaty between Switzerland and a source state. The Federal Tax Administration has agreed a

number of Mutual Agreements with foreign treaty states that entitles FCPs, SICAVs and LPCIs to ask for relief from foreign withholding taxes on behalf of their Swiss resident unit holders. Switzerland has agreed Mutual Agreements with Austria, Canada, Denmark, France, Germany, the Netherlands, Norway, Spain, Sweden, and the UK and Ireland. Australia, Japan and Canada grant withholding tax relief at source also in relation to SICAVs on grounds of Swiss address.

If no Mutual Agreement is applicable, the Swiss resident unit holder has to ask for treaty relief from foreign withholding taxes in accordance with the applicable treaty provisions.

SICAFs, however, are treated as Swiss resident persons for treaty purposes. Therefore, this collective investment scheme is entitled to relief from foreign withholding taxes under an applicable double tax treaty between Switzerland and a source state in accordance with the applicable treaty provisions.

Foreign collective investment schemes

The rules of Swiss taxation of income from units of foreign collective investment schemes in the hands of Swiss resident unit holders are the same as for Swiss collective investment schemes. A foreign collective investment scheme is compared to Swiss FCPs, SICAVs, LPCIs and SICAFs and treated accordingly for Swiss tax purposes. It is of significance that foreign collective investment schemes report information in accordance with the rules of Swiss income taxation in order to avoid adverse discretionary Swiss income taxation.

Foreign collective investment schemes may be subject to Swiss taxation if they lack substance abroad and are effectively managed in Switzerland.

Withholding tax

Switzerland has not become a preferred international jurisdiction for the establishment of collective investment schemes. There is a tax reason for this: income from units in Swiss collective investment funds are subject to Swiss WHT. The Swiss WHT levied on income of Swiss collective investment schemes is a significant obstacle for non-Swiss resident investors and the reason that Swiss international financial institutions use offshore partnerships and offshore corporations in international fund structuring.

FCPs, SICAVs and LPCIs that are approved by the Swiss supervisory authority in accordance with the CISA are treated as taxpayers for Swiss WHT purposes. In this regard, these collective investment schemes are not transparent. Income from units of these collective investment schemes is subject to Swiss WHT at a rate of 35% irrespective of whether the income is distributed (*Ausschüttungsfonds*) or accumulated, i.e. at the moment of debiting in the account of reinvestment (*Thesaurierungsfonds*).

Swiss WHT arises at the moment the distributed income becomes due (*Ausschüttungsfonds*) or the accumulated income is credited (*Thesaurierungsfonds*). The collective investment scheme is obliged to withhold the Swiss WHT from the gross income and to pay it to the Federal Tax Administration.

If the collective investment scheme demonstrates that income will be sourced continuously from foreign sources to a minimum of 80%, it may ask the Federal Tax Administration to be exempted from Swiss WHT to the

extent that income is paid or credited to a foreign resident unit holder ("affidavit procedure").

Exempted from Swiss WHT are capital gains and income from Swiss and foreign real estate that is directly owned by the collective investment scheme and repayment of paid-in capital if the income is distributed by the FCP, the SICAV or the LPCI to the unit holder by means of a separate coupon.

Swiss WHT may be refunded fully or partially according to Swiss domestic tax law or an applicable double tax treaty. In accordance with Swiss domestic tax law, a Swiss resident unit holder is entitled to a full refund of the Swiss WHT. Foreign resident unit holders are entitled to a full refund of Swiss WHT if the income is sourced from foreign sources to a minimum of 80% ("Affidavit Procedure"). If a double tax treaty between the resident state of the foreign resident unit holder and Switzerland is applicable, the foreign unit holder is entitled to full or partial refund of the Swiss WHT.

In contrast to FCPs, SICAVs and LPCIs, SICAFs are always treated as taxpayers for Swiss WHT purposes, irrespective of whether they were approved by the Swiss supervisory authority in accordance with the CISA. Income from units of this collective investment scheme is treated as dividend and subject to Swiss WHT at a rate of 35% if distributed. The repayment of paid-in capital is not subject to Swiss WHT. The Affidavit Procedure is not applicable.

6.2 Carried interest

In the field of private equity investments, it is common that the fund manager participates in the profit of the collective investment scheme. This profit participation is called carried interest. The Swiss income taxation of the carried interest depends on the legal form of the Swiss resident fund manager and the particular collective investment scheme. Income from fund management qualifies as income from self-employment activity in the hands of a Swiss resident individual and as taxable profit in the hands of a Swiss resident company. If Swiss resident fund managers who are employed with the fund management company hold their own units in the collective investment scheme or participation in the fund management company, such units and participations generally qualify as private assets and are not imperatively related to a business activity of the fund manager. In that case, capital gains from the sale of the units and/or the participation are treated as income tax-free.

If the fund management is provided by the fund manager individually or as a partner of a partnership (rather than through a fund management company) on a contractual basis, and the fund manager or the partnership has the right to profit participation, the units in the collective investment schemes and the participation in the partnership qualify as business assets. Capital gains, income and carried interest are taxable income from self-employment activity in the hands of the Swiss resident individual fund manager.

6.3 Management equity

The tax treatment of equity participations and options to obtain equity participations in the collective investment scheme granted to management follows the Swiss tax law provisions for employment income, in particular

those on the taxation of employee participations. Equity participations and options to obtain equity participations are generally taxable at grant. Taxable employment income corresponds to the difference between the fair market value of the equity participations and the options respectively as well as the acquisition price, if any. A discount of 6% per annum is applicable for equity participations with selling blocking period. Options that are subject to a selling blocking period and options to obtain shares of unlisted equity participations respectively are taxed at exercise. Taxable income corresponds to the difference between the fair market value and exercise price. The capital gain upon the sale of the equity participation generally qualifies as private tax-free capital gain in the hands of a Swiss tax resident manager. Equity participations and options to obtain equity participations that are subject to vesting are taxable at vesting or exercise respectively.

6.4 Loan interest

Switzerland does not levy Swiss WHT on interest paid on individual loans. However, interest paid by a Swiss borrower to Swiss or foreign lenders for the purpose of collective financing or on bank deposits is subject to interest withholding tax at a rate of 35%. A collective financing is present if a Swiss borrower issues a bond. A bond consists of written debt acknowledgments with fixed amounts that are issued either in more than 10 tranches at comparable conditions (*Anleihensobligationen*) or more than 20 tranches at variable conditions (*Kassenobligationen*). Bank deposits include more than 100 interest-bearing deposits without fixed amounts that are issued on a continuous basis. Swiss and foreign banks are not taken into account for the calculation of the Swiss-borrower 10/20/100 Non-Bank Rule. Switzerland does not levy issuance stamp duty on the issuance of bonds.

The question as to whether commercial agreements qualify as loans, in particular bonds or bank deposits, is answered under Swiss tax law on a substance over form approach.

In order to avoid Swiss WHT on interest, a Swiss borrower and the lender jointly agree to include in credit facilities so-called Swiss borrower language according to which the lender may not assign any of its rights and benefits (including sub-participations) or transfer (by way of novation or assumption of contract) any of its rights, benefits and obligations to another person without prior written consent of the Swiss borrower.

6.5 Transaction taxes

Units issued by FCPs, SICAVs and LPCIs are not subject to Swiss federal issuance stamp duty and not subject to Swiss federal turnover stamp duty. The sale and purchase of units is, however, subject to Swiss federal turnover stamp duty at a rate of 0.15% if a Swiss securities dealer (e.g. a Swiss bank) is involved either as party or intermediary. Redemption of units is not subject to Swiss federal turnover stamp duty.

Units issued by SICAFs are subject to Swiss federal issuance stamp duty at a rate of 1% but not subject to Swiss federal turnover stamp duty. The sale and purchase of units is subject to Swiss federal turnover stamp duty at a rate of 0.15% if a Swiss securities dealer (e.g. a Swiss bank) is involved either as party or intermediary. The sale and purchase of units is subject to Swiss federal

turnover stamp duty at a rate of 0.3% if a Swiss securities dealer (e.g. a Swiss bank) is involved either as party or intermediary. Redemption of units is not subject to Swiss federal turnover stamp duty.

Units issued by foreign collective investment schemes are not subject to Swiss federal issuance stamp duty but subject to Swiss federal turnover stamp duty at a half rate of 0.15%. The sale and purchase of units is subject to Swiss federal turnover stamp duty at a rate of 0.3% if a Swiss securities dealer (e.g. a Swiss bank) is involved either as party or intermediary. Redemption of units is not subject to Swiss federal turnover stamp duty.

7. CURRENT TOPICAL ISSUES/TRENDS

The Swiss investment environment remains very attractive despite the strength of the Swiss franc. Switzerland remains a typical "buyer's market" with many companies that are in search of funds. This global trend appears to be driven by the situation in the US and, although the local market is showing a certain resistance, there is a comparatively strong pressure on pre-money valuations in Switzerland too. Furthermore, the skills and quality of the employees are often perceived as an additional asset by private equity funds when investing in Switzerland.

Currently, there is a positive environment in Switzerland for exiting investments. There have been a number of exits. Usually, exits have been achieved through trade sales/merger and acquisition transactions, including a number of research and development/intellectual property transactions. It is interesting to note that exits have also been achieved at earlier stages than usual and that trade sales have not been limited to large companies but have included a number of medium-sized investments.

Swiss start-ups have attracted attention in recent years, particularly through sales to larger companies. One downside is that investment from Swiss capital, such as through domestic pension funds or traditional banks, remains very low. The gap can be partially offset by foreign investors but domestic 'pioneer' investors would benefit even more from the potential available.

According to a recent study by Dealroom.co for 2015–17, Switzerland also has the lowest ratio of all European countries: on average, only a quarter of the capital ultimately invested in startups over the entire period was collected through Swiss VC funds. (*Swiss Venture Capital Report* (2018)).

The trend continues that a couple of transactions involve a listing on the stock exchange and/or listed companies. Exits by way of IPOs are not so common due to the substantial risks of loss of value during lock-up periods. However, particularly in the biotech sector, exits by way of IPOs on the SIX Swiss Exchange and the US Nasdaq have been seen in the last few years.

The worldwide increase in regulations is expected to continue to have a strong impact on how private equity is carried out.

In this context, the private equity structure developed by legislation in Switzerland, i.e. the LPCI (see s.2.1 above), may become attractive, the more so if the current interesting investment environment can be maintained. Much will, however, depend upon the ability of Switzerland to develop transparent and attractive rules for the taxation of performance fees of general partners/managers. Adaptation to the upcoming regulatory developments in

Europe will also be key.

The rapid evolution in FinTech has not only attracted the attention of FINMA but eventually pushed the Swiss Government to propose FinTech-specific amendments to the Banking Act of 8 November 1934 and other financial laws. A new Banking Ordinance entered into effect on 1 August 2017 designed to reduce barriers to entry for FinTech firms and to strengthen the attractiveness of the Swiss financial markets.

The new regulation sets out a legal framework suitable for all existing and future FinTech companies as well as other actors satisfying the legal conditions. The three major amendments are:

(1) deadline extension for settlement accounts for the period to 60 days to suit crowdfunding models;
(2) an exemption for innovative companies from requiring such a banking licence. They should be able to take more than 20 deposits from the public provided that the total amount held does not exceed CHF 1 million; and
(3) introduction of a new category of banking licence, the so-called "FinTech licence".

It remains to be seen whether these modifications will increase FinTech start-ups and stimulate their development in the next few years.