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Farewell to bearer shares and introduction of criminal sanctions?

Farewell to bearer shares and introduction of criminal sanctions for violations of transparency obligations?

On 17 January 2018, the Swiss Federal Council launched the consultation *(Vernehmlassung)* on the implementation of the recommendations of the Global Forum on Transparency and Exchange of Information for Tax Purposes *(Global Forum)* regarding the transparency of legal entities and the exchange of information. This is the beginning of the legislative process and it is expected that the proposed legislation will be deliberated in the Swiss Parliament in winter 2018/2019.

The proposed legislation foresees, *inter alia,* the automatic conversion of bearer shares *(Inhaberaktien)* into registered shares *(Namenaktien)* by operation of law as well as a tightening of the transparency obligations under Swiss corporate law by introducing criminal sanctions for breaches of the transparency obligations. The proposed legislation includes further proposals concerning administrative assistance in tax matters. This article will only address the corporate law aspects of the proposed legislation.

If implemented, the proposed legislation will lead to a number of actions to be taken and risks to be considered by Swiss companies and their (Swiss or foreign) shareholders.

Background of the proposed legislation

The Global Forum aims to ensure that the OECD standards regarding transparency and the exchange of information for tax purposes are complied with and are implemented in a uniform manner internationally.

To that end, the Global Forum conducts peer reviews in two phases. Whereas phase 1 examines the existence of the necessary legislative framework, phase 2 focuses on the degree of implementation of the legislative framework in practice. The Global Forum uses ten evaluation criteria and grades countries as "compliant", "largely compliant" (both of which are deemed sufficient), "partially compliant" or "non-compliant" (both of which are deemed insufficient). Failure of a country to obtain a sufficient grade entails the risk of reputational loss as well as the risk of the G20, the EU or other countries implementing "defensive measures" such as a partial or complete revocation of double taxation treaties with the country in question.

On 26 July 2016, the Global Forum published the phase 2 peer review report on Switzerland, in which it graded Switzerland as "largely compliant". Out of the ten evaluation criteria, two were graded "largely compliant" and further two only "partially compliant". In particular, according to the Global Forum, Swiss law does not currently ensure sufficient transparency of non-listed companies in spite of the new disclosure obligations in art. 697i et seqq. of the Swiss Code of Obligations *(CO).* Those disclosure obligations were introduced in 2015 in the context of implementing the 2012 recommendations of the Financial Action Task Force *(FATF),* which has as its objective to combat money laundering, terrorist financing and other related threats to the integrity of the international financial system.

The Global Forum's peer review report included recommendations on how to ensure a positive rating, which must be implemented until mid-2019 in order to be considered in the next assessment of Switzerland's compliance.

Proposed legislation

Elimination of bearer shares

Proposal of the Swiss Federal Council

The Global Forum's peer review report on Switzerland focused, *inter alia,* on bearer shares and held that the current statutory obligations are not sufficient to ensure that holders of bearer shares are identified.

In light of this finding, the Swiss Federal Council proposes that non-listed companies will only be entitled to issue registered shares. Companies that have listed at least one part of their shares on a stock exchange will, however, still be able to keep or issue bearer shares since the transparency of these companies is guaranteed through the reporting obligations in the Financial Market Infrastructure Act *(FMIA).*

According to the proposed legislation, at the time of its entry into force, all bearer shares of non-listed companies will be converted into registered shares automatically by operation of law. No action of the company or its shareholders will be required in that regard. This applies regardless of whether share certificates for bearer shares have been issued or not.

Shareholders who hold bearer shares at the time the new legislation enters into force and who have already identified themselves vis-à-vis the company in accordance with art. 697i CO will be entered in the share register *(Aktienbuch).*

Holders of bearer shares who have not yet identified themselves vis-à-vis the company by the time the new legislation enters into force will be granted a grace period of 18 months to still make the necessary notification. While the identification obligation of holders of bearer shares pursuant to art. 697i CO shall be abolished, the explanatory report *(Erläuterungsbericht)* of the Swiss Federal Council dated 17 January 2018 *(Explanatory Report)* implies that the requirements for the shareholders' identification during the grace period shall, in essence, still be governed thereby. In particular, the holders of the converted bearer shares will need to identify themselves by means of an official identification document or an extract from the commercial register and provide proof of their shareholder status in principle by presenting the respective share certificate(s). Upon a successful identification during the grace period, the shareholders will be entered in the share register.

After the expiry of the grace period, shareholders who have not identified themselves will definitively lose all rights attached to the shares. Their shares will be deemed void and the company will need to issue, in place of such void shares, new shares as treasury shares.

The companies will be obliged to adapt their articles of association to reflect the conversion of the bearer shares into registered shares within two years after the new legislation has come into force and no other changes of the articles will be entered into the commercial register until this obligation is complied with.

Is the proposed measure appropriate?

Since the elimination of the anonymity of bearer shares in 2015, there are only minor differences between bearer shares and registered shares from a practical point of view. Additionally, bearer shares are under increasing scrutiny nowadays and, thus, become less and less popular in practice. As stated in the Explanatory Report, the predominant part of newly incorporated companies in Switzerland have opted to issue registered shares and a significant number of existing companies (more than 800 companies from July 2016 to June 2017) have voluntarily converted bearer shares into registered shares. Against this background, the legislative proposal does not come as a surprise. However, the proposal is not coherent yet and raises concerns from a constitutional point of view.

First, the Swiss Federal Council's suggestion for proof of shareholder status during the grace period falls short. Pursuant to the Explanatory Report, a shareholder only needs to present the share certificate(s) to the company to prove its shareholder status. This would indeed be sufficient to prove a shareholder status for bearer shares. However, as of the entry into force of the new legislation all bearer shares will be converted into registered shares by operation of law. Thus, from this date until the identification, any transfer of the shares will be governed by the rules applicable to registered shares which provide for the following transfer regime: If share certificates have been issued, a transfer of registered shares requires in addition to the transfer of possession, an endorsement on the back of the share certificate or a separate assignment. If no share certificates have been issued, registered shares are transferred by way of assignment. The company will have to ensure compliance with those requirements if the shares are transferred after the entry into force of the new legislation. In such case, the company will need to verify additional documents (endorsement, assignment declaration) to verify the shareholder status. Otherwise, the transfer regime for bearer shares would be upheld and wrongfully applied to the transfer of registered shares.

Second, the provision according to which shareholders who have not identified themselves during the grace period will definitively lose all rights attached to the shares could raise concerns as to the constitutional guarantee of ownership (art. 26 of the Swiss constitution). In this context, the Swiss Federal Council states that nothing new will be introduced and that the proposed procedure resembles the procedure in art. 681 CO, according to which the board of directors may declare that the shareholder who failed to timely pay the issue amount has forfeited its rights in respect of the share subscription *(Kaduzierung)*. Whereas such procedure may be plausible if the shareholder does not fulfil its main obligation to pay the issue amount for its shares, the automatic loss of all rights attached to the shares after the grace period seems to be a rather harsh measure to sanction the non-compliance with an identification obligation. Instead, the new legislation could for example also operate with fines – as proposed for infringements of other transparency obligations.

The proposal furthermore foresees that the shares of those shareholders who have not identified themselves during the grace period are deemed void and that the company shall issue new (registered) shares as treasury shares. Unfortunately, the proposed legislation does not address the corporate law issues that might arise as a consequence of the issuance of treasury shares. The Explanatory Report merely states that, if the nominal value of the treasury shares exceeds the statutory permitted threshold of 10% of the share capital, the excess will have to be sold or cancelled by means of a capital reduction. According to art. 659 CO, this would need to be done within two years. Depending on the specific circumstances, it could be challenging and even legally impossible to dispose of the excess treasury shares within such a short timeframe.

Recommendations for companies and shareholders

In light of the proposed legislation, we would encourage companies to consider converting bearer shares into registered shares prior to the entry into force of the new legislation. Thereby, companies would not only avoid acting under time pressure, but also avoid the uncertainties which might arise due to the automatic conversion or the declaration of certain shares as void if holders of bearer shares failed to identify themselves in time.

A conversion of bearer shares into registered shares will require a respective amendment of the articles of association and a respective entry into the commercial register. If physical share certificates have been issued, they should be called in, cancelled and, if desired, re-issued as registered shares by the companies.

Holders of bearer shares who have not yet identified themselves vis-à-vis the company should do so as soon as possible in order to comply with the already existing statutory obligations. Furthermore, if the proposed legislation enters into force, the shareholders would avoid the risk of losing the title to their shares in case they fail to identify themselves during the grace period.

If a shareholder identifies itself within the proposed grace period, the company will need to verify the shareholder status of such shareholder. In doing so, it is recommended that the company requests, in addition to the presentation of the share certificate(s), a written confirmation from the shareholder that (i) it was holding the shares represented by the share certificate(s) at the time the new legislation entered into force and (ii) such shares have not been transferred since then. If the company is or becomes aware of share transfers since the entry into force of the new legislation, it will need to verify that such shares have been validly transferred in compliance with the transfer requirements for registered shares. In the rather exceptional circumstances where no share certificates for bearer shares were issued, the company will need to verify the shareholder status by reviewing the share transfers (to be effected by way of assignment) since the company's formation.

Introduction of criminal fines for infringements of transparency obligations

Proposal of the Swiss Federal Council

Under the current law, for as long as a shareholder does not comply with its disclosure obligation, namely to disclose the beneficial owner(s) after acquiring at least 25% of the equity or voting rights in a company, its membership rights (in particular the voting rights) are suspended and its property rights (in particular the right to dividends) may not be asserted. If the shareholder complies with its disclosure obligation after the one-month statutory notification period, it may exercise the property rights arising from that date only and, hence, any claims having accrued prior thereto are deemed forfeited. The Global Forum considers these sanctions to be insufficient to ensure the transparency of companies.

In light of this finding, the Swiss Federal Council proposes to introduce criminal fines for intentional infringements of both (i) the shareholders' obligation to notify the company of the beneficial owners of the shares and changes thereof, and (ii) the companies' obligation to correctly maintain the share register as well as the register of beneficial owners. With regard to the latter, an infringement will be attributed to the individuals acting on behalf of the company

based on general criminal law principalsvis. Hence, a fine would, in particular, be imposed on the members of the board of directors. Since no specific fine amount is provided for in the proposed legislation, the general statutory maximum of CHF 10'000 would be applicable for infringements of those obligations.

Is the proposed measure appropriate?

The introduction of criminal fines was already discussed in the context of the 2015 amendments of the Swiss Code of Obligations, but was rejected by the Swiss Parliament as being unnecessary. From a legal point of view, the introduction of criminal fines seems problematic in view of the so-called certainty principle in criminal law *(nulla poena sine lege certa),* because the answer to the question "Who is the beneficial owner, if any?" is anything but clear.

Whereas art. 697j CO states that the beneficial owner of the share is the natural person for whom the acquirer of at least 25% of the equity or voting rights is ultimately acting, art. 2a para. 3 of the Anti-Money Laundering Act *(AMLA)* defines the beneficial owner as the natural person who ultimately controls the legal entity by directly or indirectly, alone or in concert with third parties, holding at least 25% of the equity or voting rights or otherwise controlling it.

The determination of the beneficial owner is still not clear in cases of a cascade or multilevel structure with intermediary legal entities as no uniform approach for such determination exists. If the wording of art. 697j CO is strictly followed, the acquiring (direct) shareholder reaching or exceeding a participation of 25% would need to disclose all individuals that hold at least one share of the ultimate parent company or any intermediary company. Such approach is discarded by (almost) all scholars for practical reasons since it would lead to an enormous flood of data. Basically, three approaches have been established in the legal doctrine in the context of a cascade or multilevel structure with intermediary companies:

— Under the first approach, the shareholder acquiring at least 25% of the equity or voting rights in a company needs to disclose all individuals holding a participation of at least 25% in an intermediary company or the ultimate parent company, provided that for each level of participation the intermediary company also holds a participation of at least 25%. This first approach relies on the definition of the beneficial owner used in art. 2a para. 3 AMLA.
— Under the second approach, the shareholder acquiring at least 25% of the equity or voting rights in a company needs to disclose all individuals holding a qualified participation of at least 50% (instead of 25%). The same threshold of at least 50% applies also to participations of intermediary companies. The second approach is based on the commentary to the Agreement on the Swiss Banks' Code of Conduct *(CDB 16)* with regard to the exercise of due diligence, according to which effective control is deemed to exist only when an individual holds more than 50% of the equity or voting rights in an intermediary company.
— Under the third so-called multiplication approach, a beneficial owner needs to be disclosed if a participation of at least 25% exists on every level of the cascade (as under the first approach) and the multiplied participations amount to at least 25%. For example: If A acquires 25% of the shares in the target company and C holds in turn 60% of the shares in A, C does not have to be disclosed as beneficial owner since 60% of 25% equals 15%, which is below the 25%-threshold.

It is apparent that the three approaches will lead to different results when identifying the beneficial owners. While the first approach is the safest since it will produce most beneficial owners to be disclosed, the third approach is the riskiest since, except for certain rare constellations, the fewest beneficial owners will need to be disclosed to the company.

In our view, the beneficial owner should be determined by using the second approach based on the commentary to the CDB 16 as the mere rationale behind the obligation to disclose the beneficial owner is to support the transparency measures required by the laws on combatting money laundering. In that context, the banks and other financial intermediaries identify the beneficial owner in accordance with the CDB 16. Since any Swiss entity will be required to open an account with a Swiss bank and will, hence, be subject to the banks' indirect supervision (see below), the applicability of the same approach by companies seems only logical. This is reinforced by the proposed inspection right of the financial intermediaries which allows them to inspect the share register and the register of the beneficial owners of the company in order to comply with their own obligations under the AMLA.

Given the uncertainty as to which approach will be followed by the courts (in particular by the Swiss Federal Supreme Court) and the fact that the three approaches lead to quite different results in relation to the identification and disclosure of the "beneficial owner", it is highly questionable whether the criminalized action is sufficiently defined to be made subject to criminal sanctions. It would be more than appropriate, if not necessary, to have the introduction of criminal sanctions accompanied with a legislative clarification of the disputed issues.

Recommendations for companies and shareholders

The companies should implement one of the three approaches and apply the chosen approach consistently to all reporting shareholders. Whereas we believe that the second approach is the most appropriate, considering the prospect of being subject to criminal fines, the companies might consider taking the "safest road" and apply the first approach for determining the beneficial owner (disclosure of all individuals who hold shares of the ultimate parent or an intermediary company exceeding a threshold of 25% of equity or voting rights).

To limit their liability the shareholders and companies are well advised to consult a legal advisor in that regard. In practice, if the company has inquired about the approach to be followed and obtained "incorrect" information, a justifiable mistake about the unlawfulness of the act may be assumed, provided that the shareholders or companies were not able to identify the information as being incorrect. Hence, if the Swiss Federal Supreme Court eventually supports an approach that has not been chosen by a certain shareholder or company, such shareholder or company might excuse itself based on the received advice from a legal advisor.

Other proposals to ensure compliance with the transparency obligations

The proposed legislation includes further mechanisms to ensure compliance with the transparency obligations of legal entities.

According to the proposed legislation, a company's failure to rightfully maintain the required registers (share register and register of beneficial owners) shall be deemed a defect in the company's organization. In such cases, the shareholders, the creditors and the commercial registrar will have the right to request the court to order appropriate measures, i.e. to request from the company to restore the rightfulness of the registers under the threat of its dissolution. It is questionable whether this proposal is appropriate. First, the circle of potential claimants is too far-reaching since neither the creditors nor the commercial registrars have access to those registers and, therefore, are in general not in a position to substantiate their claims. Second, shareholders might misuse this possibility to enforce other objectives.

Outlook and a look abroad

Further, it is proposed that Swiss companies as well as Swiss branches of foreign companies (including sole proprietorships *(Einzelunternehmen)* with an annual turnover of more than CHF 100'000 as well as partnerships *(Personengesellschaften))* will be required to open an account with a Swiss bank which is subject to the Swiss Banking Act. Thereby, an indirect supervision shall be ensured given that the banks will have to identify the ultimate beneficial owner in accordance with the provisions of AMLA (and CDB 16). To facilitate the banks' duties, the proposed legislation provides that the banks, as well as other financial intermediaries, are entitled to access the company's share register and register of beneficial owners to the extent required for the fulfillment of their duties.

The proposed legislation shows that bearer shares of stock corporations which are not listed on a stock exchange will most likely be abolished. Furthermore, the transparency obligations are here to stay and will, by tendency, be further tightened. Swiss companies and their shareholders would, hence, do well to closely monitor the legislative developments and to (re-)assess their compliance with the current register for bearer shares and the statutory transparency obligations.

The consultation proceeding will continue until 24 April 2018 and it is expected that the proposed legislation will be deliberated in the Swiss Parliament in winter 2018/2019. It remains to be seen which elements of the proposal will be upheld or overturned and which of the necessary clarifications, if any, will be added in the course of the parliamentary deliberations.

Due to the efforts of both the Global Forum and the FATF, the above-mentioned issues are raised not only in Switzerland, but in many other countries as well. While many of these measures are contemplated and discussed in each of them, the measures which are (eventually) implemented vary from country to country. In that regard, the CMS publication *"Transparency Register, an overview of foreign reporting requirements"* (cms.law/en/INT/Publication/Transparency-Register) may provide you with a helpful overview of the different transparency regimes currently in place in various countries.

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