

# Make them pay

**Thomas Lustenberger, Alexander Vogel and Laurence Ruckli of meyerlustenberger explain the Swiss rules on remuneration and the public debate surrounding them**

**E**xcessive remuneration of corporate officers has been a much debated topic in Switzerland over the last 10 years. The financial crisis has made this debate both more emotional and political with the launch of an initiative to change the constitution. But the public is still outraged. Not only were governments forced to bail out financial institutions that were responsible for the excessive bonuses, the remuneration systems themselves are believed to be the very cause of some of the disastrous developments in the financial markets.

In Switzerland, no other company is as exposed to public criticism as UBS. The bank, prevented from collapsing by a government bailout plan, brought the public debate to a climax after announcing that it would still pay bonuses for the crisis-ridden year of 2008. Other large multinationals have not done much to avoid the spotlight and improve the top managers' image. Recently, Credit Suisse was criticised when it announced that its CEO Brady Dougan would receive CHF90.1 million (\$81.5 million).

Since 2001, the public debate on manager remuneration has become more and more important. As a first result, a set of rules was enacted requiring the disclosure of information relating to the remuneration of the members the board of directors and of the senior management. In addition, most listed companies in Switzerland apply International

Financial Reporting Standards (IFRS) and are therefore subject to the disclosure regime relating to management compensation provided therein.

However, transparency had not really done much to resolve the problems of excessive and inadequate remuneration schemes. The financial crisis has now tremendously increased the pressure on politicians to tackle the problem. Currently, the initiative against rip-off salaries, as well as counterproposals of the Federal Council and of different political parties are intensively and emotionally discussed. In the months or years to come, the parliament and then most likely the Swiss citizens, will have to take decisions on the subject.

## Current rules

The Swiss Code of Obligations (SCO) does not allocate the power to decide on remuneration issues relating to board members and members of top management to a specific corporate body. Indeed, it does not explicitly raise the issue. Hence, if the articles of association do not allocate such power to the shareholders, it is up to the board of directors under its general power to manage the company to decide on remuneration issues. In listed companies, the board usually installs a remuneration committee to prepare the respective decisions. As a general rule in Switzerland, the board not only decides on the compensation of the top management but also on its own remuneration.

Swiss law does allow the allocation of the power to decide on remuneration issues to the shareholders' meeting. To date none of the Swiss listed companies has made use of this possibility. However, recently a number of large companies have introduced a consultative vote by the shareholders on the remuneration report, as suggested by the Swiss Code of Best Practice.

The SCO contains the only set of rules on reporting obligations with regard to executive compensation enacted by the Swiss legislator. The SCO provisions entered into force on January 1 2007 and replaced the former provisions in the Corporate Governance

Directive (CGD) issued by the SIX Swiss Exchange (SIX) in July 2002. The CGD only required the disclosure of aggregate salaries paid to the management and members of the board, with the highest remuneration to be disclosed on a no-name basis. While the CGD is applicable to all issuers listed on the SIX, the new rules provided for in the SCO apply to all companies with a domicile in Switzerland and which are listed on a Swiss or foreign stock exchange.

According to the SCO rules, companies must disclose individually the remuneration packages of directors. With respect to top management it is sufficient to disclose the aggregate amount of their remuneration. However, the highest compensation paid to a member of the top management must also be disclosed together with the disclosure of name and function. Auditors have to verify full compliance with those provisions.

The term "compensation" is described in a non-exhaustive way and includes, among others, severance payments and pension benefits. Further, the SCO does not define who belongs to the top management. Depending on the organisational structure of a company, members of different management levels may qualify as top management.

The enhanced transparency provided by the new rules was designed to strengthen the control rights of shareholders by furnishing them more information. Only informed shareholders are in a position to exercise their voting rights in the election of board members intelligently. Or, at least, they should have the information basis that allows them to take an informed decision to sell or keep their participation. The rules were also meant to influence the decision preparers and makers to be responsible and moderate when fixing remunerations.

The SIX requires via its CGD Swiss and foreign issuers whose shares are listed on the SIX to disclose certain information, in particular in the annual report, eg relating to group structures, major shareholders, the issuer's capital structures, transfer restrictions and nominee regimes.

When the SCO rules were introduced on January 1 2007, the SIX decided to revoke most of its disclosure rules regarding compensation since they were similar to the new rules provided for in the SCO. The CGD still contains provisions about the disclosure of the system and the determination process for the compensation of top management.

The Swiss Financial Market Supervisory Authorities (FINMA) issued a circular on remuneration schemes which entered into force on January 1 2010 (FINMA Circular).

The FINMA Circular sets minimum

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standards for the structure, implementation and disclosure of remuneration schemes for financial institutions which are subject to FINMA supervision and which are required to meet minimum equity requirements, whether they are listed or not. Currently, only seven banks and five insurance companies meet the criteria. Nevertheless, FINMA recommends that the other financial institutions observe the principles as best practice guidelines.

The FINMA Circular contains detailed rules on how companies must structure and monitor their remuneration systems. Further, it is requesting a summary disclosure of the remuneration structure for all employees and not only of the board of directors and the senior management as well as a disclosure of the aggregate amount of all remunerations.

One rule contained in the FINMA Circular has recently been the subject of discussions, not only among bankers but also among labour lawyers: the FINMA Circular requires that an employer must defer payment of part of the remuneration for a period of up to three years to the extent required in light of its risk profile. The controversy turns around the question whether such a deferral of salary payments is compatible with labour law.

While the SCO rules aim at improving the shareholders' rights and position, the FINMA Circular's main focus is to make financial institutions structure their remuneration in a way that does not award incentives for taking inappropriate risks and which uses variable remuneration to promote the institution's sustainable development.

The Swiss Code of Best Practice for Corporate Governance (Swiss Code of Best Practice or Code) issued in 2002 by Economiesuisse, the largest umbrella organisation representing Swiss businesses, also addresses issues of remuneration. The Code is designed as a guide for Swiss listed companies and contains recommendations which are – obviously – non-binding. However, in practice the recommendations of the Code are highly regarded and are observed and followed to a large extent by most listed Swiss companies. In 2007 Economiesuisse introduced amended rules on remuneration that are contained in an appendix to the Code.

With regard to remuneration, the Swiss Code of Best Practice recommends companies to set up a compensation committee that consists exclusively of independent members of the board of directors. The committee's main task is to shape an adequate remuneration policy for members of the board and the top management, based on guidelines given by the board. The committee should ensure that the remuneration packages are in conformity with market conditions for the

## Author biographies



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Thomas Lustenberger is a partner in the corporate team and Chairman of the firm's executive committee. With his team he advises Swiss companies in all aspects relating to corporate governance. He is also the chairman or member of the board of directors of several listed and private Swiss companies, including companies active in the areas of real estate, textiles, semi-conductors, corporate finance services. He graduated from the University of Berne and obtained a Master of Laws from

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hiring and retention of professionals with the required skills and qualities. The structure of the remuneration should reward medium and long-term success, rather than short-term results. Further, the Code bans golden parachutes and severance payments.

The new rules recommend that the board of directors should produce a compensation report for the shareholders' meeting which describes the compensation system and its application in the business year under review. It suggests that the shareholders' meeting should be involved in the debate on the compensation system in either of two ways:

Option one: the compensation report is discussed during either of the two agenda items approval of the annual financial statements or discharge of the board of directors. It is then assumed that the approval of either of the agenda items implies the approval of the compensation report.

Option two: the board of directors submits the compensation report to the shareholders' meeting for a consultative vote, a Say on Pay

as it is implemented in the UK since 2002 and meanwhile in other European countries as well. The shareholders can express their view by voting on the compensation report but the outcome of such vote is non-binding and does not have any legal consequences.

Option one has been criticised because a shareholder may disapprove of the compensation report but still agree with the financial statements. The same is true for the discharge of board members which is by no means necessarily linked to the compensation report. The Say on Pay option will be discussed below.

The shareholders of Swiss companies do not have the right to vote on the remuneration of members of the board and senior management. However, a limited number of large Swiss companies have followed the Say on Pay option recommended by the Swiss Code of Best Practice. This option has also been actively supported by certain mutual funds and other institutional investors or their advisers.

By the end of April 2010, 21 of the 100 largest Swiss listed companies, 14 of which belong to the Swiss Market Index, have given their shareholders a Say on Pay at the 2010 shareholders' meeting. Novartis' shareholders will hold a consultative vote on the remuneration system at their next year's general meeting, but this vote will be based on a new provision in its articles of association providing for a tri-annual consultative vote concerning significant changes to the compensation system.

### Political moves

On December 21 2007, the Federal Council published a report on the comprehensive reform of company and accounting law. However, the compensation topic was only addressed in depth by the Federal Council's report of December 5 2008 which is an amendment to the 2007 report and a reaction to the initiative against rip-off salaries launched in February 2008. Due to the financial crisis, the Federal Council very recently took first steps to initiate further measures regarding compensation practices of financial institutions.

The initiative against rip-off salaries proposing to amend the constitution will have to be put to a public vote by the government. It demands, among other governance related issues, that shareholders of listed companies have, by law, to approve of the aggregate amount of compensation paid to all members of the board of directors and separately, of the senior management on an annual basis. It, further, prohibits categorically golden parachutes, advances on remuneration as well as bonuses in the event of M&A transactions. A violation of the provisions of the initiative would be considered a criminal offence. Further, the initiative demands that the articles of association, *inter alia*, determine the structure of the remuneration packages of board and top management and the duration of latter's employment agreement.

Because the Federal Council considers the initiative to be too rigorous and unattractive for important companies, it published its 2008 report as an indirect counterproposal to the initiative. The counterproposal wants to deal with the issues on the level of a bill only and not on constitutional level and it does not suggest penal sanctions.

In many points regarding remuneration, the counterproposal is similar to the initiative. Like the initiative it provides that the shareholders have the right to vote on the total remuneration of the board of directors. However, regarding the total remuneration of the senior management, it only proposes a consultative vote, unless the articles of association provide otherwise. The

counterproposal suggests that the board of directors must determine remuneration policies, which need not be part of the articles of association and issue a remuneration report, which needs not to be audited nor approved by the shareholders' meeting. The counterproposal does not prohibit specific elements of compensation.

To secure the functioning of the financial system and to send a signal out against excessive compensation in the financial sector, the Federal Council recently decided to implement more effective financial market regulations and instructed the Federal Department of Finance to prepare by autumn 2010 rules in three areas of compensation practices:

Salary systems of financial institutions that have to seek government assistance must be subject to separate restrictive regulations.

The variable remuneration components paid by financial institutions that depend on company profits should no longer be treated as personnel expenses for tax purposes, but as profit distribution and be taxable as corporate profit.

Employee stock options should no longer be taxed when they are granted, but when the options are exercised.

All reform proposals in the area of compensation practices of listed companies are currently the subject of intensive and controversial discussions in the parliament and by the media and the public. In the beginning of June 2010, the parliament decided to extend the period for the debate on the initiative against rip-off salaries until August 26 2011, much to the resentment of many politicians who wanted to have a solution while the topic is still hot. As a consequence, changes in the law are not to be expected before 2013.

### Open issues

Remuneration transparency for listed companies is in place in Switzerland and that is beneficial for the shareholders. The question is: have the rules made an impact on the remuneration policies and on salary levels? There can be no doubt that the rules have contributed to a remuneration process that is based on more objective criteria and is subject to a more transparent process. Transparency has probably influenced remuneration committees to be more cautious when fixing remunerations. But salaries have not really gone down nor have excesses been prevented. Comparisons within business sectors have, in some instances, even led to higher salary levels.

When looking at the latest tendencies which aim at involving the shareholders in the remuneration process either by a decision on remuneration or by a consultative vote, the

question is: is the general meeting of a public company the right body to assess the many issues that come into play when determining remuneration? Are decisions not likely to be affected by emotion rather than by long-term thinking? Systematically, a decision on manager salaries by the shareholders' meeting seems wrong. The board is responsible for their employment.

The consultative votes of shareholders in 2010 on the remuneration reports all resulted in an approval by a vast majority. Only those of UBS and Credit Suisse were approved against strong minorities, 45,3% and 33,8% respectively. Given the shareholder structures of large companies, this outcome is not surprising despite the heavily criticised remunerations systems. The UK experience with eight years of Say on Pay has shown the same result with only eight votes not approving. However, the effect of the involvement of the shareholder' meeting has caused the discussion on salaries to become public with the media intervening. Reputation risks become closely felt by all involved persons, be they the managers or the members of the compensation committee.

The initiative against rip-off salaries certainly reflects the general public's opinion on irresponsible manager salaries. But its very rigorous content goes further than the international benchmarking in this field and creates new issues. Is it appropriate to make governance issues, which always involve discretion, the subject of penal sanctions and does the existing penal law not offer enough options where criminal acts are committed? How do we deal with remuneration schemes that are not approved by the shareholders? Is one of the likely options that directors and managers have to, or will, resign mid-year with all the problems that creates for the company?

Switzerland has always had a liberal and flexible company law that allowed businesses to adapt to changed circumstances which has helped to attract foreign businesses. Switzerland should try to effectively tackle the problem of excessive remuneration but not at the price of over-regulation, even though the emotionality of the public discussion requests action with no compromise. The time extension now decided by parliament should give the responsible government agencies as well as the political parties time to develop sensible solutions which find the support of majorities. It seems very well possible that the consultative vote on the remuneration report becomes part of such a solution.