VISCHER

Minder Initiative

Federal Council passes regulation against excessive remuneration in Swiss listed companies

On 20 November 2013, the Federal Council passed the ordinance against excessive remuneration in listed companies ("Ordinance") which will now enter into force on 1 January 2014. This implements Article 95 paragraph 3 of the Federal Constitution, which dates back to the adoption of the popular "against rip-off" initiative. The finalised Ordinance differs in several respects from the draft, which was published in June 2013 before entering the consultation process. The transitional provisions provide that the companies affected will be granted transitional periods in several areas.

Who is affected?

The Ordinance applies to companies limited by shares with headquarters in Switzerland, whose shares are listed on a stock exchange in Switzerland or abroad, as well as to Swiss pension funds. Swiss companies limited by shares whose shares are not listed and foreign companies listed in Switzerland are not affected. All companies and institutions formed under Article 763 CO, e.g. cantonal banks and certain insurance and electricity companies, which have been established on the basis of the cantonal laws and are managed with participation of public authorities, are also exempt from the provisions of the new Ordinance.

The new compensation rules apply to the Board of Directors, the Advisory Board and the Executive Board, i.e. the members of the committee which reports directly to the Board. Employees on a lower hierarchical level are not affected.

What needs to be done?

1. Adjustment of Bylaws

The affected companies must amend their bylaws. Some of the adjustments are compulsory whereas others are only necessary if the content is intended to be binding on the companies. At the latest, the bylaw adjustments must be made at the second Annual General Meeting after the Ordinance comes into force.

Mandatory Bylaw Content

- **External activities:** The bylaws must contain provisions on the number of activities in which its members of the Board of Directors, the Advisory Board and the Executive Board are permitted to engage in legal entities that are required to be registered in the commercial register or a corresponding foreign register, and which are neither controlled by the company nor control the company. The Ordinance does not state a specific maximum number of company-external mandates. According to the circular of the Swiss Federal Commercial Registry Office (EHRA) of 20 November 2013, the maximum number only requires to be determinable. It is also permissible to differentiate on a factual or manpower basis, e.g. set different limits on the permissible activities in other listed as opposed to non-listed companies or for full-time as opposed to part-time activity as a director or executive officer.

- **Contract duration and termination time limits:** Both the maximum duration of fixed-term contracts as well as the maximum notice period for indefinite contracts with the members of the Board and the Executive Committee must be fixed in the bylaws. New under the Ordinance is that the duration of fixed-term contracts as well as the notice periods for indefinite contracts can not exceed one year.

- **Compensation Committee:** The basic principles of the tasks and responsibilities of the Compensation Committee must be included in the bylaws. The General Assembly has to annually determine the members of the Board who will sit on the Compensation Committee. Apart from that, the companies are free to organize the Compensation Committee.

- **Approval of remuneration:** The bylaws must regulate the details of the voting procedure of the General Assembly on the remuneration of the company officers. Unlike the preliminary draft, the finalised Ordinance does not include fall-back provisions on the voting mechanism. The legal requirements for the bylaw regulation of the vote on the remuneration are merely that it is (1) annual, (2) separate for the total amount of remuneration for the Board of Directors, the Executive Committee and the Advisory Board, and (3) binding i.e. not merely consultative. Within these broad parameters, the companies are free to choose whether the approval of the respective total remuneration is retrospective, prospective or a combination of both.

  Companies can also choose whether the General Assembly can only approve the remuneration proposal of the Board or may pass another (e.g. lower) remuneration proposal from shareholders. Since, according to the transitional provisions of the Ordinance, bylaw adjustments must be made no later than at the second Annual General Meeting after the date the Ordinance comes into force, it is possible and permissible, if the prospective authorization variant is chosen, that the first submission to the General Assembly for approval of remuneration will be for the 2016 financial year.

  In the bylaws companies can also regulate the further steps necessary in case the General Assembly does not pass the remuneration proposal. As with the preliminary draft, the Ordinance does not answer the central questions as to what compensation companies may pay to the members

of their executive bodies if the General Assembly rejects the proposed remuneration and what remuneration can be paid for the period between the end of the business year (or the last approval period) and the next General Assembly. In its supplementary report, the Federal Office of Justice states only that bylaw provisions which, in the case of rejection of the proposed remuneration, apply the most recently approved remuneration are not permitted and neither are provisions that defer the decision on remuneration to the Compensation Committee. In order to create a degree of legal certainty in relation to companies' wage payment obligations to their executive bodies it is recommended to cover, in the bylaw provisions, the procedure in the event that the General Assembly rejects the remuneration proposal.

A possible bylaw provision would be to allow the Board to make a second remuneration proposal to the General Assembly for which a different, lower approval quorum applies. In particular, it could be provided that abstentions – e.g. for a second remuneration proposal by the Board those of an independent proxy without instructions – should be treated as no votes cast rather that being considered as "no" votes. For the same reasons, it is also recommended not to grant the shareholders a right under the bylaws to propose the remuneration amounts and to provide, in the bylaws, for a prospective approval of the total budget or at least the fixed and possibly the long-term variable remuneration components of the executive bodies' remuneration.

Potentially necessary bylaw content

Under the Ordinance certain payments and measures of the company require to be based on the bylaw provisions in order to be binding and valid. Certain payments to members of Board of Directors, the Advisory Board and the Executive Board are therefore only prohibited if they are not based on the bylaws or if they do not meet the requirements laid out in the bylaws. If the bylaws govern these types and components of remunerations and the compensation payment is compliant with the bylaws, they are still allowed.

According to the Ordinance, this bylaw qualification applies to:

- **Loans, credits and retirement benefits:** The amount of loans, credits and pension benefits outside the employment related retirement benefits for the members of the Board of Directors, the Executive Committee and of the Advisory Board shall be included in the bylaws. According to the circular of the EHRA, it is sufficient if the amount is definable.

- **Performance-related remuneration, allocation of equity securities, convertible bonds and warrants:** The performance-based remuneration and the allotment of equity securities, convertible bonds and warrants to the executive bodies (to the extent they function as compensation) also require to be based on the bylaws. However, only the principles and not all details need to be addressed in the bylaws. In particular, the performance and participation plans of the management require to neither be an integral part of the bylaws nor an annex thereto despite this having being requested during the consultation process.

- **Authorizing the transfer of management:** The transfer of

management by the Board of Directors in accordance with an organizational regulation still requires to be based on the bylaws. Unlike the preliminary draft, the Ordinance also clarifies that the transfer of asset management to legal entities remains permissible if there is a corresponding authorization in the bylaws. This allows, in particular, the listed investment companies to continue their previous organization.

- **Additional amount:** The companies will sensibly be allowed to provide in the bylaws for an additional amount of remuneration for members of the executive bodies, who are appointed after the General Assembly has voted on that year's renumeration. This "buffer" may only be used if the total amount of remuneration approved by the General Assembly is not sufficient. The additional amount can only be utilized until the next remuneration vote of the General Assembly. The additional amount does not require to be specified in a precise monetary amount; it is sufficient if the shareholders can determine it from the bylaw wording (e.g., expressed in percentage points of the total remuneration of the management). An additional amount calculated on the basis of such a bylaw provision does not require to be approved in the next General Assembly.

- **Procedure when the General Assembly does not pass the proposed remuneration:** Unlike the preliminary draft, the Ordinance contains no rules on how to proceed in the event of a negative decision on remuneration by the General Assembly. Under the new provisions companies will be allowed to regulate the measures and details in the bylaws (see above).

- **Vacancies:** The Board of Directors is responsible for the appointment of the Chairman, a member of the Compensation Committee and the independent voting proxy in the event of a vacancy during a term of office. Companies are, however, permitted to provide in the bylaws for a different procedure for resolving such organizational issues.

- **Controlled companies:** In their bylaws companies can regulate the remuneration of its executive officers for their activities in companies that are directly or indirectly controlled by the company.

Further bylaw amendments

Depending on the content of the existing bylaws it may also be necessary to adapt any provisions that conflict with the Ordinance, in particular with respect to (1) the annual election and term of office of each member of the Board and Chairman of the Board, (2) the new compulsory responsibility of the Board of Directors for the preparation of a Compensation Report, and (3) the annual election of an independent proxy by the General Assembly and the abolition of all other forms of institutional proxy voting.

2. Preparation of the Compensation Report

Under the new provisions the Board of Directors must annually, initially for the financial year that starts at the same time or after the Ordinance comes into force, prepare a written Compensation Report for submission to the Annual General Meeting. The Compensation Report must include details of

the remuneration of the Board of Directors, the Executive Committe and the Advisory Board or their related parties. In preparing the Compensation Report, the principles of proper accounting must be observed. The accounting requirements applicable to the Compensation Report can be found in Articles 958c 958d paragraphs 2-4 and 958f OR.

The newly created Compensation Report replaces the appendix to the accounts in which the information was previously contained. The Ordinance states in detail what information the Compensation Report must contain and in respect of which individual company officers or bodies or so-called related persons *(nahestehende Personen*). The provisions generally correspond to the former Article 663b*bis* OR. The Ordinance does not envisage a vote on the Compensation Report.

The Compensation Report must include all compensation, as well as outstanding loans and credits which the company has granted directly and indirectly to the current and former members of the Board of Directors, the Executive Committee and the Advisory Board. Former members of the Board of Directors, the Executive Board and the Advisory Board need only disclose remuneration that is connected with their former duties as an officer of the company or which is not market standard. Benefits of occupational pensions are also exempt from the disclosure requirement. Outstanding loans and loans to former company officers are only mentioned if they were not granted at normal market rates.

The Compensation Report must also detail remuneration, loans and credits to related persons (current and former members of the Board of Directors, the Executive Committee and the Advisory Board); remuneration, not granted at market rates; loans and credits, not granted at normal market conditions and which are outstanding. The names of the related persons do not require to be listed. Customary fees to tax consultants, law firms and other consulting firms in which a company officer has been active, do not require to be disclosed in the Compensation Report.

The auditor must consider whether the Compensation Report complies with the relevant legislation and the Ordinance. The rules for annual financial reporting to the Board and the General Assembly apply.

3. Adjustment of employment contracts

Generally unacceptable compensation

Certain elements of compensation for members of the Board of Directors, the Executive Committee and the Advisory Board are newly inadmissible per se. The making and receiving of such payments may also be criminally sanctioned if there was intent. The prohibition applies in principle from the entry into force of the Ordinance on 1 January 2014. New employment agreements completed after that date may not include such compensation elements. The Ordinance provides for a transitional period for those employment contracts in existence on 1 January 2014. These contracts have to be brought into line with the Ordinance within two years of its entry into force, i.e. by 1 January 2016. Up to this point remuneration elements which are non-compliant with the Ordinance are still permissible.

The following remunerations are covered by the general prohibition:

- **Severance payments:** The concept of severance pay is not defined in the Ordinance. According to the explanatory report of the Federal Office of Justice on the preliminary draft, the concept of severance pay was to be understood in a wide sense and means, in particular, lump sum redundancy payments, such as compensation for loss of job due to a change of control, as is sometimes provided for in contracts with Executive Committee members. Unlike the preliminary draft, the final Ordinance now clearly states that all payments owed until the termination of the employment contract are permitted and thus are not deemed severance payments. Therefore the continued payment of wages during the new maximum allowable year's notice in the case of dismissal of a manager is permissible. The same should apply when the employment relationship, is terminated by a termination agreement rather than by an immediate dismissal, provided that only the remaining contractual period will be paid. Permissible is also severance pay under Article 339b CO. Also, an accelerated vesting of options and shares under employee stock option plans is not prohibited. Finally, excluded from the ban are market-standard anti-competition clause compensation, although the explanatory report neither defines what is "market-standard" nor states what the maximum amount should be. Assuming that labour law competition bans can usually be agreed and enforced for a maximum of three years, the last annual fixed salary multiplied by factor 3 would probably set an acceptable upper limit for a competition ban compensation.

- **Advance Payments:** Also absolutely banned are advance payments, to which the company has committed or paid before the company officer was ever active for the company. Still permitted, however, are the so-called signing bonuses. According to the supplemental report, a signing bonus is compensation payable on taking up employment for the loss of valuable claims against the former employer or client (e.g., stock options, restricted shares), to which the officer would have been entitled, if he had not changed company.

- **Commissions for restructuring:** The commission ban applies to all forms of restructuring under the Merger Act and similar transactions related to intercompany transactions. The term "commission" clarifies that only compensation that is unrelated to time and expense is meant. Additional time and expense of company officers in connection with corporate transactions may therefore continue to be taken into account when determining the variable compensation.

Prohibited compensation with no basis in bylaws

In contrast to the aforementioned types of remuneration that are, without exception not valid, certain compensations paid to officers are only prohibited if they do not meet the requirements of the bylaws or if they completely lack a basis in the bylaws. Conversely, they are still allowed when the kinds of remuneration and remuneration elements are regulated by the bylaws. No later than at the second Annual General Meeting, after the entry into force of the Ordinance, the shareholders have to pass the relevant provisions for the bylaws. Until then, the payment of such compensation is permitted.

According to the Ordinance, this relates to the loans, credits and pension benefits outside the occupational pensions and the performance-based remuneration and the allocation of equity securities, convertible bonds and warrants. The aim is that shareholders can set the guidelines for such payments. In relation to loans, credits and pension benefits outside the occupational pension the amount is to be included in the bylaws, whereas for performance-based compensation and the allotment of equity securities, convertible bonds and warrants only the general outlines should be specified.

4. Immediate Need for Action

The Board of Directors must ensure the implementation of the Ordinance. With regard to the entry into force on 1 January 2014 and the preparation of the 2014 Annual General Meeting the following points require immediate action:

- The companies are obliged to have an independent proxy. The Board of Directors has to have such a proxy in place ready for the first Annual General Meeting after 1 January 2014. From 1 January 2014 corporate and custody representation is no longer permitted.

- For the first Annual General Meeting following the entry into force of the Ordinance the agenda has to include the individual elections of the President of the Board of Directors, the members of the Board of Directors and the Compensation Committee and an independent proxy holder. They are only allowed to be elected for a term of one year.

- If the bylaws do not make provision for the roles and responsibilities of the Compensation Committee, they shall be determined by the Board.

- A Compensation Report needs to be prepared for the first time for the year 2014 and needs to be audited.

- It must be ensured that the new employment contracts contain no provisions that are impermissible under the Ordinance.

It is recommended that small and medium sized listed companies make use of the transition periods of the Ordinance for the remaining points. In particular, the decision on a retrospective or prospective voting model; the definition of the affected remuneration period (business year or other period of a year); and the associated bylaws adjustments for the second Annual General Meeting after 1 January 2014.

Authors

Dr. Robert Bernet, LL.M.
rbernet@vischer.com

lic.iur. Nicolas Facincani, LL.M.
nfacincani@vischer.com

VISCHER AG

Zürich
Schützengasse 1
8021 Zürich
Switzerland
Tel +41 58 211 34 00
Fax +41 58 211 34 10

Basel
Aeschenvorstadt 4
4010 Basel
Switzerland
Tel +41 58 211 33 00
Fax +41 58 211 33 10