Switzerland – Implementation of the "Initiative against rip-off salaries": New corporate governance rules for Swiss public companies

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On March 3, 2013 the Swiss voting public – after a long and fiercely fought public debate – approved, by a large majority of roughly 68%, the so-called "rip-off initiative" which was launched in 2008 by Thomas Minder, toothpaste entrepreneur and member of the Swiss parliament (more precisely, the "Initiative against rip-off salaries" or, less sensationally, the "Minder Initiative"). Given the clear message sent by the Swiss voters, the Swiss Federal Council has followed through on its promise to rapidly implement the Minder Initiative and its key corporate governance requirements as now set forth in article 95 paragraph 3 of the Swiss Federal Constitution and, in late November 2013, published an implementing ordinance on excessive compensation in listed corporations (the "CompO") which entered into force on January 1, 2014 with immediate effect, subject only to certain transitional provisions.

The CompO fundamentally changes the legal framework on executive compensation for Swiss public companies and reflects an on-going shift in the current global corporate governance landscape towards increased shareholders' rights. Due to its rapid implementation combined with a rather brief transitional period and some fierce criminally sanctioning provisions, the CompO requires Swiss public companies to act promptly and decidedly in amending their governance structure on the one hand and to redefine their approach to the annual general meeting of shareholders on the other hand. It remains to be seen if and to what extent the Minder Initiative and the CompO will impact public M&A transactions.

This article aims to present a broad overview on the scope and some of the most prominent features – and thus of the practical implications for Swiss public companies – of the newly implemented CompO, most notably the say-on-pay regime and the provisions which, in substance, limit a corporation's freedom to compensate its board ("Board") and the members of its executive management.

Scope

The provisions of the CompO are mandatorily applicable to Swiss corporations limited by shares pursuant to articles 620 *et seq.* of the Swiss Code of Obligations ("CO") whose shares are listed on a stock exchange in Switzerland or abroad. Contrary to the existing Swiss corporate governance framework – as most notably provided for by the "Swiss Code of Best Practice for Corporate Governance" and the "Directive on Information relating to Corporate Governance" which apply to issuers whose equity securities are listed on the SIX Swiss Exchange and whose registered offices are in Switzerland only – two important distinctions regarding the scope of the CompO are noteworthy.

Firstly, the scope of the CompO extends only to Swiss corporations whose shares, and not generally equity securities or even bonds or other securities, are listed on a stock exchange. In consequence, the CompO is not applicable to a Swiss corporation with only equity-based participation certificates (*Partizipationsscheine*) or dividend rights certificates (*Genussscheine*) or bonds and other debt-based instruments listed.

Secondly, the CompO, again contrary to the traditional Swiss corporate governance framework, applies to Swiss corporations irrespective of their place of listing, both in Switzerland and abroad. Other factors, such as predominantly foreign shareholders, a centre of the corporation's business activities outside of Switzerland or its past history involving foreign elements (such as a company having solely transferred its registered seat from abroad to Switzerland in the course of a redomestication transaction for tax reasons) may not serve as a basis for an exception from the scope of the CompO.

Say-on-pay

In light of the various corporate scandals leading up to the recent global financial crisis, to the effects of which Switzerland was not immune, it comes as no surprise that the intention to strengthen shareholders' rights in a Swiss listed company lies at the centre of the Minder

Initiative and, thus, at the centre of the CompO now in force. With this aim in mind, a comprehensive say-on-pay regime is the most far-reaching novelty introduced by the Minder Initiative and the CompO.

The CompO requires that each Swiss public company concerned must establish its say-on-pay framework which, in any event, needs to comply with the following three requirements: (i) the shareholders' vote on compensation must be held annually; (ii) the shareholders' vote on compensation must be final and binding rather than merely advisory; and (iii) the shareholders' vote on compensation must be held separately for the Board, the executive management and the advisory board, if any. Within these limits, a company is free to flexibly establish its own say-on-pay framework. However, any such framework established must be reflected in the articles of association of the company ("Articles") concerned and set forth the details and nature of a say-on-pay vote including, particularly, timing aspects and the consequences of a negative outcome.

Regarding the nature of the vote, a company is faced with the choice to either submit to its shareholders the compensation proposed by the Board without offering the shareholders an opportunity to submit their own counterproposals, or, more openly, indeed allow counterproposals by the shareholders. Due to the clear incentive to deny the Board's proposal in any event if such counterproposals are tolerated, companies are likely to follow the more restrictive mode of only having the shareholders' vote on the Board's proposal without accepting counterproposals by the shareholders.

In terms of timing, the vote on compensation may be held prospectively (e.g. until the next general meeting ("GM") or for the upcoming business year) or retrospectively (e.g. covering the preceding business year). Furthermore, even a combination of prospective and retrospective elements and/or a split between different periods of time is feasible. First industry trends, particularly for compensation of the members of the executive management, seem to go towards a prospective vote on fixed compensation and variable long-term incentives while short-term incentives are generally likely to be addressed retrospectively which allows shareholders to pass a vote knowing whether or not the management has indeed reached its targets. Board compensation (for both, fixed and, if applicable, variable remuneration components) is likely to occur for a period from one GM to the next, aligning the term of office of the members of the Board with their compensation scheme.

The obvious advantage of the prospective votes is the fact that it creates predictability, and thus certainty, for the top executives concerned as a situation in which the shareholders retrospectively deny compensation for services already rendered and work already performed can be avoided.

Finally, with regard to a negative outcome of a vote on compensation, and thereby clarifying a much debated issue, the CompO now provides that in case of a rejection by the GM, again, the Articles must provide further details. In practice, the Articles could provide that the Board may receive a "second shot", i.e. the right to submit to an ongoing GM an adjusted proposal in case of a denial of the initial proposal. If rejected again or if no such second shot is set forth in the Articles, it would seem that the most practical solution would be stating a timeframe within which the Board may – or even must – call for another (extraordinary) GM with regard to the agenda item concerned. The crucial point here will be how the proxies are drafted with regard to such "*ad hoc* proposals" by the Board. In any event, it is not permissible to implement a mechanism which would deprive the shareholders of their right to ultimately resolve on the compensation element concerned such a default compensation or a shift in competencies, e.g. to the Board or to the remuneration committee.

In summary, the effect of GM resolutions (actual decision power or mere approval) and details on say-on-pay (prospective/retrospective vote and reference period) are all to be included in the Articles. There is no statutory default rule. The Articles must also provide for a procedure applicable in case of a negative shareholder vote whereby a fallback default rule in the Articles or a shift in competencies would not be permitted.

Prohibited compensations/ employment agreements

In addition to the regulation of the say-on-pay regime outlined above, a company's freedom to compensate its directors and officers has been substantively diminished by the CompO now in effect.

In line with the Minder Initiative, severance payments are not permissible unless required by law (Swiss or foreign) or owed to a leaving executive as a consequence of a judgment or order. Clarifying an issue which proved to be relevant in practice, the CompO expressly confirms that payments during a notice period of up to 12 months or fixed-term employment agreements not exceeding 12 months (i.e. payments owed until the end of the contractual relationship) do not constitute prohibited severance payments and are thus still permissible. It is in any event required that the Articles include provisions regarding the maximum duration of fixed-term employment agreements (not exceeding 12 months) and notice periods (maximum of 12 months). Non-

compete covenants and consultancy agreements for a post-employment period are still permissible unless they serve to circumvent the prohibition of severance payments. Care must thus be taken in drafting such arrangements, balancing the interests of the employees and of the company concerned.

Various other instruments containing compensatory elements, such as termination agreements, garden leaves or accelerated vesting provisions will be subject to increased scrutiny under the Minder regime. On the other end of the spectrum, at the beginning of an employment relationship, sign-on bonuses, as compensation for forfeited benefits originally granted by the former employer, will remain permissible. In contrast, mere upfront payments are considered prohibited advance payments under the CompO. Furthermore, a basis in the Articles is required for all other benefits (other than post retirement-benefits), loans and credit facilities extended to top executives.

A new reporting element introduced by the CompO is a separate compensation report, the contents of which must reflect the information currently required in the annex to the financial statements under article 663b^{bis} CO. The separation from the financial statements proved to be necessary in order to avoid conflicting shareholders' votes, on the one hand at the occasion of approving the financial statements and on the other hand at the occasion of the say-on-pay vote. Therefore, such a separate compensation report is not subject to shareholders' approval but falls under the scope of the external auditors' review/audit. It remains to be seen whether, particularly when the shareholders vote prospectively on executive compensation, such compensation reports will nevertheless be submitted to the GM for an advisory vote.

Elections and the independent proxy representative

The CompO requires that the shareholders may vote electronically, while corporate proxy (*Organvertretung*) and depositary proxy (*Depotstimmrechtsvertretung*) are no longer permissible. This significantly increases the importance of the independent proxy representative (*unabhängiger Stimmrechtsvertreter*).

Under the Minder regime and the CompO, the GM shall elect the independent proxy representative, the independence of whom will be determined in accordance with article 728 CO *mutatis mutandis* (i.e. the independence provision for the external auditors). The period of office of the independent proxy representative ends after the closing of the next GM. As per the CompO, the Board is competent to fill a vacant position, if need be.

Furthermore, the CompO clarifies that the shareholders must have the possibility to give general voting instructions in case of new (*ad hoc*) proposals (*Anträge*). In addition, the CompO determines that proxies sent back without any instructions (which, in practice, is actually surprisingly often the case), are to be calculated as abstentions. Yet, whenever the absolute majority rule applies (which is the default rule under Swiss corporate law for shareholders' resolutions), such abstentions are effectively "no" votes. Against that background, it remains to be seen whether proxies may be specifically drafted to address this issue, i.e. by stating on the proxy that it would be deemed exercised in the manner described in such proxy (e.g. supporting the Board proposal) if duly executed but sent back without any box being ticked. Further, the CompO provides that proxies and instructions are valid for the upcoming GM only.

Pension funds

The Minder initiative requires pension funds to make use of their voting rights in the best interest of the policyholders regarding elections and when voting on compensation-related matters. Furthermore, the pension funds have to disclose their voting behaviour. This novelty may, despite the increased regulation, at the same time present itself as a most welcome aspect from an economic point of view.

Criminal sanctions

While still not appropriate by any standard, the CompO sticks to the pre-settings of the Minder initiative when it comes to criminal sanctions. Intentional non-compliance with almost any of the rules under the ordinance by the relevant corporate bodies can be sanctioned with imprisonment of up to three years and a fine of up to six times the annual compensation.

Newly introduced are the 180 daily penalty units as potential sanctions if members of the management or the superior body of pension funds are in breach of the voting or disclosure duties. Now, certain criminal offences were deleted from the initial draft ordinance. In general, the CompO provides for milder criminal penalties and a restricted circle of potential offenders (only members of the Board) for certain criminal offences. In order to meet the subjective requirements of the criminal offence, a criminal offender must act against better judgment (*wider besseres Wissen*). Conditional intent (*Eventualvorsatz*) is not sufficient to make any behaviour a punishable offence.

Impact on M&A transactions

At this time, it is difficult to predict how the Minder Initiative and the CompO will impact public M&A

transactions targeting Swiss corporations whose shares are publicly listed. What is certain is that defence tactics involving amendments to compensation packages of top executives, while highly controversial under Swiss law even before Minder and the CompO, now require shareholders' approval which renders such instruments effectively useless if time is of the essence. In turn, the Minder regime facilitates, due to the compensation report and its increased transparency requirements, evaluating a target from afar, e.g. in the course of a desktop due diligence. When considering a take-over of a public company, any acquirer must be aware of the target's obligations under the Minder Initiative and the CompO, short-term until successfully completing back-end squeeze-out (merger) and taking the target private (de-listing) or long-term should one decide to maintain a listing in the target.

Transitional provisions and to dos

The amendment of the Articles to comply with the requirements of the CompO and the vote on compensation must be implemented at the GM 2015 while existing employment agreements must be amended by December 31, 2015. The duty to prepare a compensation report, however, is already effective for the business year starting on January 1, 2014 (or later). The transition periods are short and, in connection with several changes (particularly, the Articles), it is advisable to comply with the CompO rapidly and to present the revised Articles to the upcoming ordinary GM in the year 2014 in order to provide for legal certainty.

The specific implementation demands for interdisciplinary analyses in particular at the interface of corporation law and employment law. In this regard, provisions in employment agreements (e.g. maximum duration and notification periods) should be coordinated with the requirements of corporate law (say-on-pay), time-wise and from a substantive perspective.

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