

SWIPRA Policy Considerations – Executive Summary

January 2017

The voting recommendations of SWIPRA are designed to create long term shareholder value. SWIPRA has developed a framework of Policy Considerations for what constitutes, in SWIPRA’s understanding, long term and sustainable value based management. Below is an Executive Summary of these Policy Considerations to provide an overview for information purposes only. The full version of the SWIPRA Policy Considerations is available to our clients.

1 Corporations and value for society

Since both human and material resources are scarce, a central question of modern economies is how to channel these resources to their most productive uses. SWIPRA intends to contribute to this ultimate goal. It does so by providing recommendations to medium and long-term shareholders, in particular to institutional shareholders, on how to vote on items put to a vote at the annual general meeting. The general meeting is the highest corporate body and its competencies are of particular importance as they build the framework for many aspects of efficient and effective management and resource allocation inside an organization. As such, decisions by the general meeting can have a direct impact on the value creation of a company.

The recommendations of SWIPRA are designed to create long-term shareholder value. They are mindful of the reality that this goal is also intimately related to achieving sustainable social welfare. If shareholder capital were consistently misallocated to companies that do not put the capital to its most productive use, it is not only the investing shareholders that suffer but also employees, the economy more generally, and society at large. Every Swiss Franc put into unproductive projects is lacking for other, more productive uses. It is, therefore, the responsibility of a company’s board, management and investors alike to ensure that capital is allocated efficiently. Similarly, corporations that maximize shareholder value only in the short term hurt not only other stakeholders but ultimately also themselves and their shareholders in the long run, since other stakeholders will be less willing to contribute to this firm in the future.¹ It is in this sense that SWIPRA believes that the purpose of corporations is to create long-term value for society.

The specific situation of each company is unique, and it is SWIPRA’s policy to take into account specific situations when making recommendations. Indeed, as becomes clear through our detailed Policy Considerations, the wide-spread notion that companies should act according to a uniform “best practice” is problematic. Consequently, the approach of “comply or explain” may be questionable and is not a panacea. Instead, best practice is always relative to a firm’s concrete situation and companies should rather evaluate first what is best for them and their stakeholders

¹ The notion that in the long run shareholder and stakeholder welfare are aligned is only indirectly related to the question whether “corporate social responsibility” is a reliable concept for guiding investment and asset allocation decisions. Academic research has not reached a consensus as to whether investors paying attention to firms acting particularly responsibly will be able to achieve superior investment returns.



before taking the decision to comply with uniform rules. Companies would, therefore, generally do better if they move from a seemingly flexible “comply or explain” to a “decide and explain” approach. This “explaining” involves communication of companies that goes beyond mere compliance with mandatory reporting rules and is instead oriented towards sharing, without compromising the company’s competition position, the relevant information with its stakeholders about how value is created and distributed (also incorporating non-financial value drivers). Such value reporting lies within the responsibility of the board of directors and can help establish and keep trust of investors, which in turn allows the board of directors to set a long-term strategy and executive management to execute strategy with a view towards long-term value generation.

What is, therefore, useful is to formulate a general framework for what constitutes, in SWIPRA’s understanding, long-term and sustainable value-based management. This is what the SWIPRA Policy Considerations achieve. Importantly, the task of this framework is to indicate not only *that* voting recommendations will depend on the circumstances of the case, but also *how* they depend on them. This transparency is important because institutional investors have a particular responsibility towards their stakeholders in explaining why they vote in a certain fashion.

In what follows, we lay out these general principles. A client of SWIPRA can rely on us applying these principles consistently and transparently analyzing corporate governance structures and making voting recommendations. Although these principles are distilled from what we consider to be evidence-based economic analysis, they are neither absolute nor universal. SWIPRA carefully monitors ongoing and changing market practices as well as scientific and applied publications (such as regulatory rules, recommendations by industry interest groups, self-regulatory agencies, and other bodies). In general, SWIPRA updates its Policy Considerations on an annual basis, if needed. Thus, SWIPRA provides corporate governance analysis and, on this basis, voting recommendations that are consistent with the latest available legal, economic and practical knowledge.

2 A framework for value generation

A fundamental principle of value generation in corporations is that the Return on Invested Capital (ROIC) should be higher than the Weighted Average Cost of Capital (WACC). Although this principle is simple, it is rich enough to have a whole range of implications for voting recommendations for shareholders. There are many details as to how ROIC and WACC are calculated in a concrete situation. However, even a conceptual framework can already shed light on how shareholders should think about certain items put to their vote. The SWIPRA Policy Considerations relate to these fundamental factors.

ROIC reflects a company’s ability to put the left-hand side of its balance sheet to productive use. WACC reflects a company’s ability to put together the right-hand side of the balance sheet in a cost-effective manner. That is, WACC is the linkage between the internal (management) perspective and the external (capital market) perspective. Thinking about ROIC and WACC is



particularly helpful when it comes to considering whether growth creates value for a company. While growing earnings is often seen as a good thing in and of itself, what shareholders (should) ultimately care about is **long-term free cash flow and the cost of capital**. Value is generated only if, in the long run, the returns on new investments are greater than the cost of the investment. The cost of capital of a company reflects both the business risk (which in turn is a wide concept, ranging from core business aspects to broader issues of environmental, social, and governance (ESG) concerns) and the financial risk.

Digging deeper into this conceptual framework, it becomes clear that many challenges exist in achieving the goal of sustained and sustainable value generation. A list of some factors that are relevant especially from the perspective of shareholder decisions at the Annual General Meeting (AGM) includes the following **10 key concepts**. To illustrate the relevance of these concepts, in this executive summary, we give a number of **concrete implications and examples** for how the basic considerations lead to specific policies that SWIPRA has with respect to standard items on AGM agendas. No “check-the-box” system is applied and so these implications and examples can only highlight the principle ideas behind SWIPRA’s recommendations. For the detailed **reasoning** behind these policies, all of which are based on a careful analysis of state-of-the-art research in corporate governance, as well as for more in-depth analysis of trade-offs that apply in specific settings, we refer to the full text of the Policy Considerations:

1. The (product and capital) **market environment** in which a firm acts in is, to some extent, a given. At certain times, some industries are simply more challenging than others, allowing lower ROIC or implying higher WACC. But the market environment is also, to some extent, a choice variable for management, as it considers where and how to position the company. In particular when inorganic growth, such as through mergers and acquisitions, is being considered, it is important for shareholders to understand what the perspectives for a possible combined company are in the future. SWIPRA, therefore, pays particular attention to the information provided by a company in its business report regarding the current situation, developing trends, and future expectations as well as to the reasoning behind these expectations.

Concrete implications and examples:

- (1) The better a company explains **strategic considerations**, the more likely it is that shareholders can make sense of proposed agenda items.
- (2) Considerations regarding the market environment are particularly relevant in the context of votes on compensation. First, SWIPRA looks for a clear rationale why certain **benchmarks** (if any) are chosen. Second, the extent to which **exogenous factors** are taken into account **in the compensation system** should be clearly communicated and explained by the company; ex-post adjustments frequently are eyed critically by shareholders.



2. All employees contribute to the success of a company, but it is an inevitable consequence of hierarchical organizations that board and management actions “multiply” throughout the hierarchy. Therefore, they have a special impact on outcomes. By setting the “cultural tone” for the company, the board of directors and top management can have a substantial influence on corporate outcomes. **Managerial ability and character** provide both opportunities and constraints on the returns that can be achieved from employing resources, and the risks incurred when pursuing these returns. SWIPRA puts a premium on understanding how board members directly and indirectly contribute to this success factor and to which extent the composition of the board provides an optimal variety of such competencies. SWIPRA takes a broad view and, in evaluating the actions and contributions of the board and of management, also considers personal risk factors such as reputation, experience and dealing with general risk management aspects, ethics and social responsibility because concerns regarding these factors may negatively affect future cash-flows. These considerations drive, for example, SWIPRA recommendations regarding **elections of members of boards of directors, the chairman of the board, and the members of the compensation committee.**

Concrete implications and examples:

- (1) SWIPRA primarily focuses on whether **independent behavior** that is in the interest of the long-run value of the company can be expected from a board nominee, taking into account a committee’s composition and the composition of the board as a whole. We derive indications of future behavior as a board member from certain factors that enter typical classifications of boards (e.g. current or prior executive employment at the company and other standard criteria), but we pay particular attention to the **competence** of board members and the **skill matrix** of the overall board and to the board rotation processes in place.
- (2) Academic evidence does not support a requirement of the separation of the CEO and chairman roles. SWIPRA, therefore, carefully considers on a case-by-case basis whether in a particular situation a **dual mandate** is appropriate. SWIPRA does not apply a fixed rule that would forbid executives from serving on the board of directors (except, naturally, where this is required by law) but will carefully consider the functioning of checks and balances and the independence of the overall board.
- (3) SWIPRA does not apply a fixed threshold for the number of mandates of board members. SWIPRA does carefully monitor potentially “busy directors” problems, recognizing that the most experienced and, thus, value-adding directors tend to have many other opportunities. SWIPRA primarily considers the **overall availability of the board candidate to the company**, which, in SWIPRA’s view cannot be determined solely from the number of meetings attended or the absolute number of other mandates. Importantly, as each case



differs, SWIPRA will make its recommendations on the basis of information provided by the company.

- (4) In general, SWIPRA recommends that companies provide information on the **planned committee assignments**, in particular of newly elected board members; this information is important to evaluate whether there is a match between the proposed board member and the needs of the company. Despite the benefits of having a clear rationale behind planned committee assignments and despite the fact that board members are elected individually according to Swiss law, SWIPRA also always considers the **board as a whole**. SWIPRA will occasionally raise general concerns with companies if it considers the board overall to be unbalanced.
 - (5) SWIPRA is of the opinion that the **compensation committee, the audit committee and the risk committee** requires particularly careful attention when it comes to ensuring the absence of conflicts of interest and the well-functioning of the internal governance process. Thus, SWIPRA will assess the **expertise and qualification** of all candidates for a seat on committees. “**Busy board**” problems can be of particular concern, as can be the role of **executive board members**. Here, too, SWIPRA does not have an inflexible approach but considers the overall governance quality by taking into account, for example, whether some committee sessions are held without executive management present, in particular in the compensation and audit committees.
 - (6) SWIPRA will also pay attention to how board members have managed overall risks in the past and, in particular also how they address CSR factors in the overall risk management in general
3. In most public corporations, there is a separation of share ownership and decision-making (control). Thus, the ultimate owners of the equity capital do not take operational decisions. This is true also in companies with a concentrated ownership structure, though perhaps in a less pronounced fashion. The source of this separation is that shareholders may not be able or willing to collect all the information necessary to make operating or even strategic decisions. Indeed, for an individual shareholder, it is fairly costly to contribute to management supervision or actual company management. These costs are in particular high relative to the benefits the shareholder receives when the total value of the company is divided up into many small pieces. (That is, shareholders face what economists call a collective action problem.) To address this problem, most of the power is by law delegated to decision-makers, in particular the board. The board then in turn delegates most of this power on to executive management. The board and top management ultimately acts for shareholders, resulting in a so-called **agency problem**. (There are also agency problems between the board of directors and management, between senior management and junior management, between junior management and general employees, etc.) This idea was recognized as a fundamental challenge in corporate governance by, for example, Berle and Means (1932). For example, one of the central problems in this respect is that managerial



“effort” (which is a broad term that captures many aspects of managerial behavior) is not contractible. While shareholders would like to specify that the manager should engage only in actions that are value-creating, the manager may have his or her own interests also. For example, a classic problem analyzed by Jensen and Meckling (1976) is that a manager who owns only a small stake of a firm will engage in excessive “perk” consumption (such as buying nice art for the office). More damaging, some managers may engage in inefficient empire building, acquiring other companies even if this is a negative net present value investment, solely for the reason to govern a larger company. The efficiency of internal resource allocation and, as such, the generation of ROIC, is, therefore, at stake. The board of directors has a special responsibility in devising ways of managing the agency problem. Consequently, SWIPRA pays significant attention to the board election. Other aspects, such as capital structure choices, governance mechanisms, and the incentive system also play a role for this issue. They are discussed in what follows.

Concrete implications and examples:

- (1) Regarding **board elections**, see the examples given under point 2 above.
 - (2) The academic literature does not, overall, provide evidence of an economically significant impact of a **dual-class equity structure** per se. However, there is evidence that the larger the wedge between voting and cash flow rights, the more negative becomes the impact of a dual-class structure on shareholder value. SWIPRA generally recommends voting in favor of unifying a capital structure, subject to the condition that the transfer from a dual-class to a unifying structure does not overly dilute the position of the existing regular shareholders.
 - (3) For dual-class companies with a large wedge between cash flow and voting rights, SWIPRA generally believes that no restriction on a **mandatory bid rule** (such as opting-up or opting-out of the rule) should be in place.
 - (4) SWIPRA would in general recommend voting for the abolishment of **transfer and/or voting restrictions**.
4. Agency problems cannot be “solved”, they can only be addressed in a more or less effective manner. Several **governance mechanisms** – a strong board, blockholders, the market for corporate control, incentive systems, external monitors such as auditors, analysts, and regulators – are put in place to address these issues. Shareholders elect **auditors**, and SWIPRA analyzes factors such as auditor independence, auditor fees, and auditor governance when making recommendations regarding these elections. **Incentive systems** play an important role today, also in the discussion between companies and shareholders. A conceptual insight here is that a company cannot *not* incentivize its employees and managers. There are always incentives in place, whether implicit or explicit, whether monetary or non-monetary. SWIPRA expects companies to recognize the reality that a reward system needs to be a *total* reward system. That is, the board should take into account a broad range of factors that influence the incentives of employees to contribute to



the company and to enhance ROIC. The Policy Considerations regarding compensation schemes consider, therefore, factors such as alignment of the scheme with firm value (and, thus, strategic firm targets set by the board of directors), the quality of the link between performance and pay, the long-term orientation of the scheme, and a range of important design issues for both cash bonus plans and equity-based compensation plans.

Concrete implications and examples:

- (1) Companies should communicate why the chosen incentive system is overall a “**best fit**” with the company strategy.
 - (2) In assessing whether the **compensation governance** is well-designed, SWIPRA evaluates, among other things, whether there is an explicit compensation policy in place, whether the roles of the compensation committee and overall board are clearly defined, and whether the way in which compensation consultants and benchmarks are used is made transparent.
 - (3) SWIPRA takes into account whether the **non-executive members of the board** of directors receive an appropriate compensation mix that supports their independence as well as their orientation towards the long-term welfare of the company. In general, SWIPRA favors either fixed cash pay or a moderate extent of equity-based pay for these board members.
 - (4) An **executive compensation** system should align executive pay with performance and strategy execution and should provide appropriate incentives for the future. SWIPRA in particular assesses the extent to which management is induced to consider profitability as well as the cost (i.e. including risks taken) and the amount of capital invested (in the sense of a residual income consideration).
 - (5) SWIPRA conducts checks of the **pay-performance relationship** by putting changes in operating and shareholder performance in context of changes in compensation. SWIPRA also expects companies to provide sufficient information about how and by which measures pay and performance are related.
5. **Asymmetric information** between management, the board and the market is a key challenge for many firms. Naturally, management and board do not want to share all information with the market, as this can lead to competitive disadvantages. By definition, management wishes to have an information advantage over others. On the other hand, if asymmetric information is too pronounced, shareholders may worry about so-called adverse selection, in the sense that other market participants assume that board and management may abuse their information advantage. The rational reaction of shareholders in such a circumstance then is to demand a risk premium (for example, in the form of a liquidity risk premium as less investors trade in these stocks). This causes higher costs of



equity and a higher WACC. Similarly, the trust of regulators and government authorities as well as of other stakeholders in the company is vital. In sum, **communication** inside the firm as well as externally with the capital market, regulators, and other stakeholders is an essential success factor for companies today. SWIPRA evaluates in particular the complete business reports in the light of this aspect.

Concrete implications and examples:

- (1) As a fundamental point that applies to most items on AGM agendas, SWIPRA will make its recommendations on the basis of **information provided by the company** in order to properly assess specific cases.
 - (2) A frequent issue in practice concerns the transparency of compensation reports. SWIPRA is mindful of the fact that certain information cannot be divulged for **competitive reasons**. However, companies should whenever possible compare actual achievement of executives to performance targets and communicate this relation. A general statement that performance targets are business secrets is not sufficient in today's environment and may be true for select performance targets only. The information policy also depends on the say-on-pay regime a company has chosen. For example, in a fully prospective voting system with no ex post advisory vote, SWIPRA applies stringent standards in assessing the transparency of the proposed compensation amounts.
 - (3) SWIPRA recommends (but does not require) that companies disclose in a separate table, the **actually realized payouts of pay plans for recent years**.
6. **Risk-taking** is another important topic. All entrepreneurial activities entail risk; innovation by definition is also risky. Interestingly, the common perception is that shareholders must worry about excessive risk-taking by managers. This certainly rings true when observing some recent cases. Nonetheless, it is worth recalling that the very source of the agency problem between shareholders and managers, at least in the standard framework of economics, is that shareholders are well-diversified and more risk-tolerant than managers. Managers are often under-diversified (especially when they hold equity stakes in their companies) and thus potentially risk-averse. Therefore, managers in principle take too little risk for shareholders' taste (and by doing so may forgo high ROIC investments). Selecting managers and board members with the risk appetite that is suitable for the current situation of the firm and having a balanced incentive system that encourages entrepreneurial thinking, combined with appropriate controls and adequate disclosure of risks, is a central success factor that governs SWIPRA's recommendations on a range of issues.

Concrete implications and examples:

- (1) In reviewing compensation systems, SWIPRA pays attention to whether the **reward system** induces management to also consider risks taken (for



example, by way of adjusting profitability numbers by taking into account cost of capital as explained in point 7).

- (2) If performance shares (where vesting is conditional on additional performance targets being met) or stock options are used, SWIPRA looks for information proving evidence that **no undue risk-taking incentives** exist in the compensation system.
 - (3) SWIPRA considers **parallel memberships in the (nomination and) compensation committee and in the audit committee** as potentially conflicting, but, in the light of existing evidence does not implement a strict rule to issue an automatic against recommendation in case a company wishes to have some overlap between the two committees. SWIPRA will be looking for information from the company on the processes in place to ensure that the required work of the audit committee regarding assurance of the quality of compensation governance, i.e., compensation processes and decisions by the compensation committee (and the board), can be conducted independently.
 - (4) Corporate social responsibility (CSR), i.e. the integration of environmental, ethical, consumer, and human rights concerns into business strategies and operations, and the corresponding reports are receiving significant attention nowadays, especially for large, multinational companies. It is, therefore, important for risk management to move from a narrow shareholder view to a broader stakeholder view by incorporating **CSR**. SWIPRA will be looking for an explanation by companies as **to how and by whom** these broader risks are addressed within a company's risk management, overall strategy and incentive systems.
7. Related to the previous point, business risk (broadly defined) and financial risk are reflected in the WACC of a company. That is, an essential insight of corporate finance is that **WACC is not exogenously given**. A fundamental idea here is that financial leverage increases the risk that equity is bearing. For highly levered companies, therefore, equity holders demand high returns *because* equity is risky in this particular case. This contrasts with the occasional argumentation that for firms with a high cost of equity, it is not attractive to issue additional equity. If such a company issues more equity, then the financial risk equity bears decreases and a lower risk premium will be demanded.

Concrete implications and examples:

- (1) SWIPRA carefully monitors whether a company's board explains well in its business report what the company's WACC is. This shared understanding is important for allowing investors to judge whether their capital is put to the most efficient use, in particular when evaluating proposals regarding share buybacks and dividends.



- (2) As noted above, in reviewing compensation systems, SWIPRA pays attention to whether the **reward system** induces management to also consider cost of capital, i.e., business risks (both in the narrow sense and in the broad ESG sense) and financial risks.
8. More generally, the **capital structure** – the choice between equity, debt, and other instruments – can be a value driver through effects not only on WACC, but also on ROIC. One aspect is the traditional trade-off between tax benefits of debt and costs of financial distress which occur as a company approaches bankruptcy.² This trade-off is often hard to quantify in a specific company’s context, but nonetheless it provides a useful conceptual tool for SWIPRA’s analysis. In addition, there are also more subtle, but sometimes quite important other issues that have to do with agency problems between shareholders and debt holders. A classical problem in the relationship between equity and debt is the asset substitution problem, according to which shareholders may have incentives to take high asset risk because they benefit from the theoretically unlimited upside but are limited in their loss on the downside by their invested capital. Another reason why SWIPRA pays attention to the capital structure of firms is that excessive debt may also lead to the debt overhang problem; companies too deep in debt may find it exceedingly difficult to raise future funds, limiting the company’s ability to implement positive ROIC projects³ Finally, another topic combining issues of capital structure and governance concerns the potential conflict between different groups of shareholders, for example, large and minority shareholders. This issue becomes relevant, for example, at times of issuance of additional share capital and when the share structure is to be adjusted.

Concrete implications and examples:

- (1) SWIPRA is generally recommending voting in favor of ordinary, authorized, and conditional **equity capital increases**, yet diligently considers the circumstances under which an equity issuance is or may be launched and considers certain differences across the methods. In any case, SWIPRA requests that companies explain their considerations in choosing the amount, addressing in particular the issue of an implicit **dilution** of the current shareholders that are capital constrained.
- (2) Regarding dual-share structure, mandatory bid rules, and restrictions of transferability, see the examples given under point 3 above.

² These costs may be direct bankruptcy costs, but they may also consist of indirect costs, such as employees, suppliers and customers leaving the company.

³ Under perfect market assumptions the capital structure is irrelevant to firm value, as established by the enormously important benchmark theorem of Modigliani and Miller (1958). The theorem remains important because it highlights that value cannot, in principle, be created by simply introducing some financial restructuring. Only when the assumptions break down – such as when markets are not competitive, when there are distorting taxes, when there is asymmetric information, when there are transaction costs, or when capital structure has an influence on the cash flows of the company – does capital structure become relevant to firm value.



9. SWIPRA notes that shareholders do well to recognize that their welfare depends on the contributions of many other stakeholders; the successful firm is good at “team production” in the sense that neither capital nor labor alone are sufficient for achieving the good outcomes and high ROIC. As pointed out by Jensen and Meckling (1976), the firm is, in fact, “a nexus of contracting relationships.” In other words, a multitude of stakeholders contribute to and participate in the success of corporations. In this context, the so-called **hold-up** (or extra-contractual incentives) problem is another essential feature of relations inside a company. On a conceptual level, the issue is the following.⁴ If an economic agent, such as a manager, makes a firm-specific, human capital investment (such as learning about the particular products of the firm), this investment increases the value of the company and hence the wealth for all stakeholders in the firm. However, when this manager faces a board or shareholders who may, at the end of the year, not provide him with a fair reward for his engagement, two problems can arise. First, costly renegotiation (with ensuing psychological costs) occurs; second, and even before making these specific investments, the manager may think twice about making them, knowing that he may be “held up,” not receiving the full returns on his investment. The hold-up problem also exists between firms.⁵ An important way to mitigate the issue derives from the **credibility** of a firm and from the way in which firms engage in **cooperations** with suppliers and customers. In general, therefore, SWIPRA considers that more credible companies will find themselves in better positions to promise rewards for specific investments of their stakeholders. This may induce stakeholders to make greater firm-specific investments, contributing to ROIC of the company.⁶

Concrete implications and examples:

- (1) When assessing the **say-on-pay voting regime** a company proposes (an agenda item especially relevant in the 2015 proxy season for Swiss listed companies due to the implementation of the “Ordinance against Excessive Compensation” and remaining relevant as companies are considering whether their implementation of say-on-pay is working sufficiently well), SWIPRA notes that companies face a trade-off: Subjecting all or part of variable pay to

⁴ See Hart (1995) for a comprehensive, accessible treatment. Grossman and Hart (1986), Hart and Moore (1990), and Williamson (1975) provide some of the foundations.

⁵ Consider a supplier S who needs to decide whether to put in a special effort to make a supply product particularly well suited for the buyer firm B. As soon as the product has been adjusted to the particular needs of B, S cannot sell the product well anymore to the outside market. At that point, B suddenly has an incentive to threaten S to withhold payment; they will renegotiate the price, and S will not get the full returns on his investment. Of course, S knows this ex ante and will, therefore, put in less than optimal specific effort to begin with. Here, an important way of addressing the issue is integration between firms; B could buy S, for example.

⁶ An important consequence of this paradigm is that maximizing shareholder power may not, in fact, be in the interest of shareholders themselves. See, for example, Burkart, Gromb and Panunzi (1997) and Blair and Stout (1999) for conceptual arguments and Wagner and Wenk (2016) for an application to say-on-pay. However, other evidence suggests that, broadly speaking, more shareholder rights tend to be associated with higher firm value (Chi 2005; Cremers and Ferrell 2014).



a retrospective vote has the advantage that it allows shareholders to decide on compensation in light of management's performance and, thus, to make a judgment on whether the compensation in question is "deserved." Retrospective say-on-pay can in ideal circumstances offer pay for performance in its perhaps most natural form. A problem is that shareholders could – even if key performance indicators are clearly defined in advance and reached by management – deny the payout of the related amounts. Especially when the financial or economic situation of a company has worsened by the time of the AGM, shareholders may be reluctant to abide by the promises the board previously made and the board may hesitate to submit to shareholder approval its promises previously made to management.

- (2) For this reason, SWIPRA regards a **prospective voting system** – especially when combined with transparent explanations of the compensation system and a **commitment to holding an ex-post advisory vote** on the compensation report – as a valid option for many companies. SWIPRA has detailed these practical considerations in a position paper on the implementation of the Ordinance against Excessive Compensation.

10. Value that is created inside the firm ultimately needs to find a way to those who have provided resources to create it. There are two conceptually different steps here: **value transformation** and **value transfer**.⁷ First, the internal company value, which is created by efficient resource allocation, needs to be transformed into external value, namely, into an increase in the share price. Communicating that value is being created is, therefore, essential. Second, the question arises how firms should best transfer value to their shareholders. In principle, shareholders can create home-made dividends by actively selling (liquid) shares when needed. In practice, firms adopt explicit payout policies by engaging in share repurchases and dividends. Only if shareholders anticipate receiving returns on their investment in an efficient manner will they be willing to contribute funds. SWIPRA's recommendations regarding payout policy follow from this basic consideration and reflect issues such as the sustainability of the payout policy as well as tax implications.

Concrete implications and examples:

- (1) SWIPRA looks for a value reporting approach that provides a comprehensive view on how a company's strategic goals are set by the board, how financial and non-financial value drivers contribute to the achievement of these goals, how these targets and their accompanied risks (including CSR-related risks) are reflected in the incentive system for management, and how these choices ultimately support the generation of

⁷ See Labhart and Volkart (2009) for more on these concepts. Labhart (1999) and Eccles et al. (2001) provide the seminal contributions on value reporting.



value for the shareholders. These considerations play a role, for example, for the assessment of compensation proposals for management.

- (2) In SWIPRA's view, every firm should have an **explicit payout policy** to guide shareholder expectations in this regard. Deviations from such a policy are, of course, possible, but would need to be explained. A firm's payout should (a) not force a firm to forego positive investment projects that are value-increasing, (b) not obviously impair debt holder wealth, (c) be as large as possible if the two before mentioned points (a) and (b) are fulfilled.
- (3) SWIPRA believes that, given the current tax regime, shareholder value should be transferred to shareholders primarily through the channels of **share buybacks** and dividends (when conveyed in a tax-efficient manner, namely, **dividends paid out of reserves from capital contributions**). Special considerations, especially in the choice of the buyback methodology, should be given to the shareholder structure.

The detailed Policy Considerations in this document reflect the idea that when companies are able to address these challenges in an effective manner, they have a competitive advantage and will be able to sustainably create value.

3 No single “best practice“: The endogeneity problem

Many commentators make normative recommendations especially for how governance structures of firms should be constructed, referring to so-called “best practices.”

Sometimes, these remarks derive solely from an “intuitive understanding” of how firms operate or should operate; this introspective approach is incomplete at best and dangerous in most circumstances. Sometimes, these remarks do, in fact, refer to an empirical fact of this or that sort. For example, some studies have observed that a certain governance feature is associated with better performance.

Such an empirically based approach certainly has significant merits – which is why we use it, too. However, we use it with caution, keeping an important caveat in mind. What follows is known among economists as the so-called **endogeneity** problem. The problem has a technical (econometric) component, but it also has an intuitive component which is easy to grasp.

Consider the following Figure 1 (which is adapted from Adams, Hermalin and Weisbach (2010)). This graph could be the result of an empirical study that looked at the relationship between a certain governance attribute (such as board independence) and firm performance. (The same logic also applies, for example, to payout policy or other firm attributes.)



From such a study, the observer could conclude that shareholders of Firm 1 could be made better off if they adopted a similar stance as Firm 2 on the attribute in question. A proxy advisor might indeed use evidence such as that presented in Figure 1 to recommend to its clients in Firm 1 to always vote for board members with greater independence. Similarly, the proxy advisor might recommend to vote against a board member not meeting a stipulated independence requirement (for example, if the nominee is a former executive).

Unfortunately, such advice could be dangerously misguided. Figure 2 illustrates why.

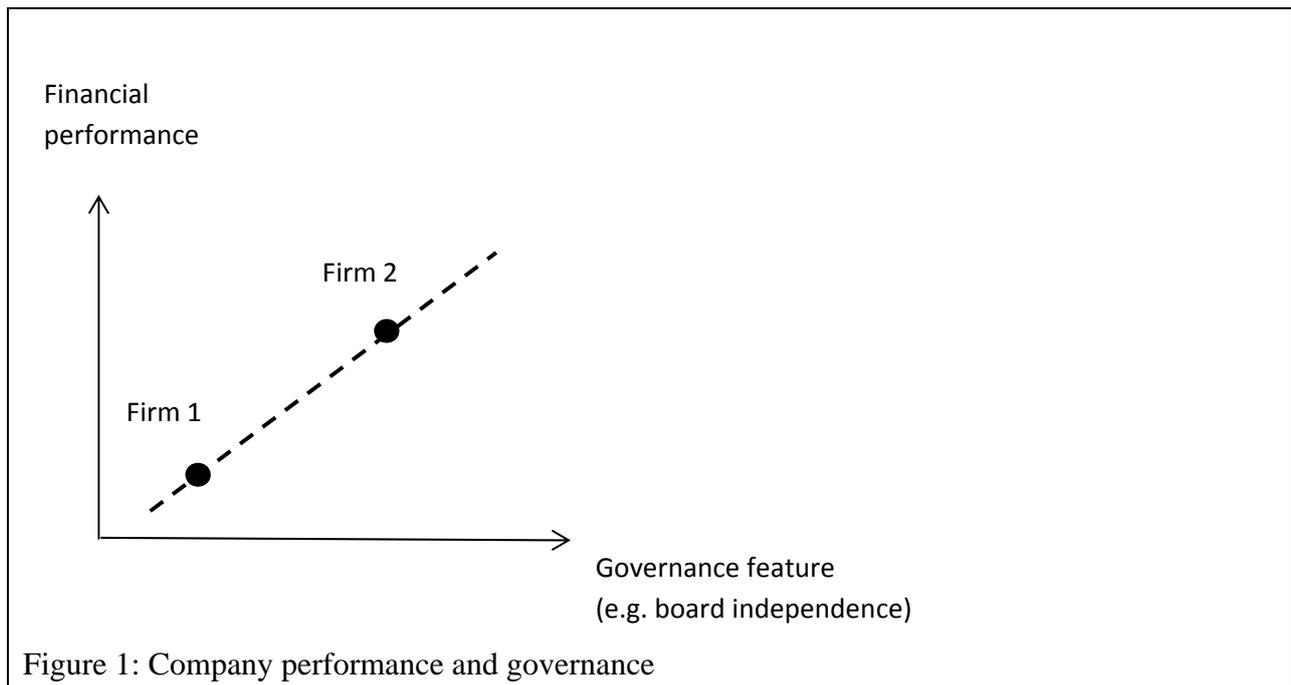
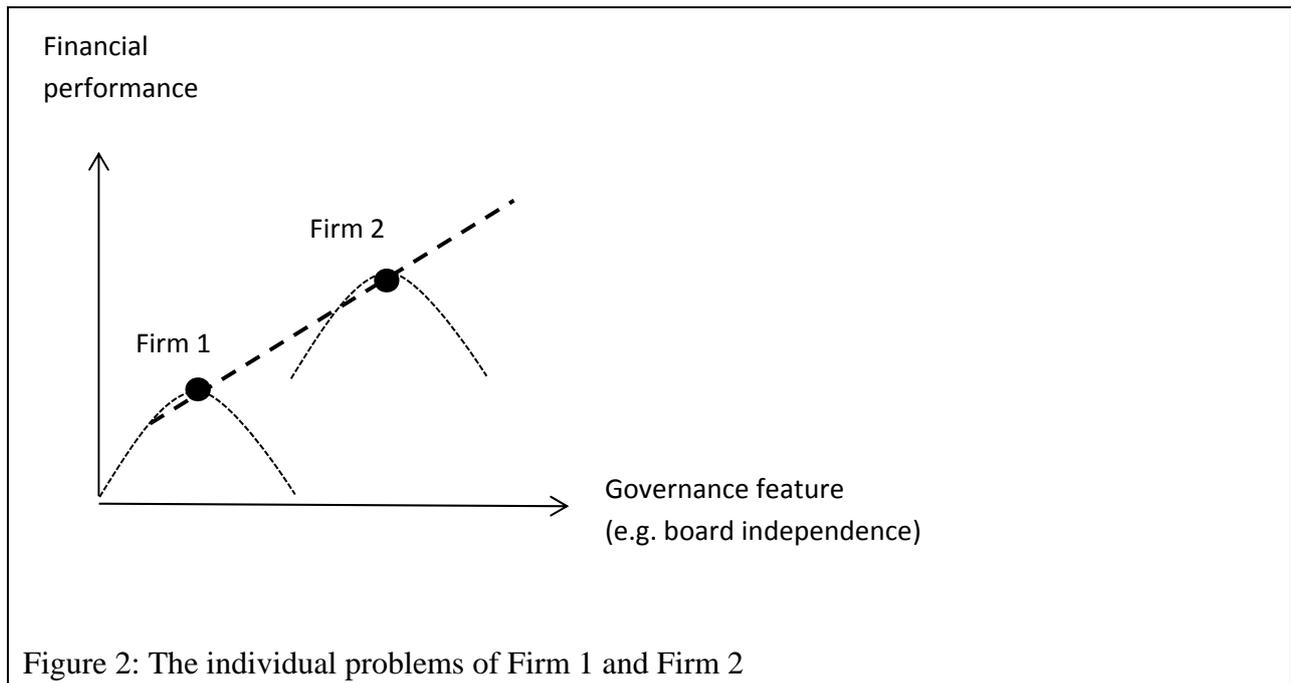


Figure 2 shows, with the dashed curves, the optimization problems that the two firms are solving. The firms face different problems. And, because they solve different problems, their optimal solutions are different. They may be in different industries; they may be at a different stage in their life cycle; etc. etc. In fact, both Firms 1 and 2 are at their *individually optimal* point. In other words, when considering data on governance, we need to keep in mind that governance institutions and other firm policies are chosen, not randomly or exogenously assigned to companies. That is, firm policies are **endogenous** to certain other, sometimes unobserved factors.



The immediate practical implication is that if shareholders of Firm 1 heed the advice of the proxy advisor who tells them “more independence is better,” they will be disappointed with the performance.

Notably, these results do not mean that nothing can be learned from empirical studies or that “anything goes.” Instead, these results put more structure and discipline on arguments and proposals for how firms should be governed. Specifically, SWIPRA draws the following conclusions from these considerations:

First, **one practice does not fit all**. There is no best practice in general; at most, there are certain best practice elements in a given situation of a company. Realistically, these can be difficult to distill from the data.

Second, when using empirical evidence to speak to certain issues (such as the role of governance for firm performance), we pay particular **attention to the methodology** used in the respective papers. We weight studies more heavily that address the just-described endogeneity concern and, thus, establish a true causal relationship between a certain characteristic and firm performance. We tend to discount studies that look at mere correlations, without addressing the fact that unobserved factors (such as different situations in which firms act) are influencing both performance and the firm characteristic of interest.

Third, companies should focus on **best practice in the process by which they communicate** their proposed governance structures and other items on the AGM agenda. For example, what SWIPRA does believe is that in proposing directors for election, it is a company’s responsibility to explain how a particular director (and the resulting composition of the board) is aligned with the company’s strategy. **A pure comply-or-explain approach therefore does not do justice to the**



complex realities that firms face. SWIPRA instead believes that shareholders are best-served if companies *explain* what they are doing and looks for relevant and informative disclosure and explanation regarding items on the AGM agenda.

Fourth, an indication that a company is operating away from an optimal point can derive from observing that a company uses a totally different governance structure than other firms in a similar position.

4 Evidence-based policy considerations: Which evidence?

As we have explained, we aim to base our recommendations on empirical research as well as rigorous conceptual considerations. We do this because our aim is to provide SWIPRA clients with a transparent set of recommendations, explaining *why* we make certain recommendations.

One challenge we encounter in this endeavor is that while a wide range of studies on corporate governance exists, many of them apply to markets other than Switzerland. Empirical studies usually benefit from using a large sample, and sample size (both in terms of the number of companies and the time horizon available) is limited in Switzerland. (This is true even though the Swiss market is of significant size. Averaging over the past ten years, Switzerland has had the 10th highest market capitalization in the world, and in November 2015 had 2.32% of the world-wide market capitalization.⁸)

Where available, SWIPRA uses studies conducted on Swiss data, and SWIPRA makes a concerted effort to support and conduct research that expands our knowledge of Swiss-specific aspects of corporate finance and governance. Some observers claim that insights from U.S. studies have limited relevance for the Swiss market because, according to these observers, U.S. corporations are entirely different in the shareholder structure. Specifically, some argue that in the US, basically all companies are characterized by dispersed ownership. As it turns out, this is a myth. For example, Anderson and Reeb (2003) establish that more than a third of companies in the S&P 500 – the largest 500 corporations in the US -- are family controlled.⁹ Thus, while care must always be exercised when extrapolating empirical evidence from one context to another, and from one time period to another, SWIPRA's opinion is that, at least to some extent, the learnings of the large empirical literature on corporate governance from outside of Switzerland can indeed inform investors' decision-making also in Switzerland. Nonetheless, SWIPRA carefully takes into account the shareholder structure and recognizes that (founding) shareholder families play a particularly important role in Switzerland. As such, SWIPRA's recommendations can in some cases markedly differ from recommendations of proxy advisors based in other jurisdictions or basing their recommendations on other criteria.

⁸ Calculated from data provided by the World Federation of Exchanges, <http://www.worldexchanges.org/statistics/>

⁹ See Faccio and Lang (2002) for evidence that family firms are the predominant ownership structure also in continental Europe (44% of the companies are family controlled).



Another facet of Swiss public corporations is that – especially in the case of large companies – a majority of shares is not held by investors situated in Switzerland, but rather by investors located internationally. SWIPRA believes that it is important that these international investors take into account the specifics of the Swiss product, labor, and financial markets. Addressing this need, SWIPRA’s team is firmly rooted in Switzerland and at the same time has significant international experience.

5 SWIPRA’s role as a critical information intermediary between issuers and investors

In SWIPRA’s view, proxy advisors¹⁰ ideally act as critical information intermediaries between issuers and their (institutional) shareholders and their specific knowledge in the area of corporate governance should add value to both, the investors as well as the issuers. SWIPRA recognizes that the expectations towards proxy advisors are quite heterogeneous. Investors and issuers value, to varying extents, the quality of recommendations, the transparency of the process of how the recommendations come about, the long-term, responsible approach, the avoidance of conflicts of interest, and the possibility of a dialogue of management with proxy advisors before recommendations are issued. It is clear that proxy advisors have to act responsibly, given that the recommendations of proxy advisors have been found to be highly correlated with the percentage of positive and negative votes.¹¹

In SWIPRA’s view, institutional investors should not blindly follow any proxy advisor. Instead, in the companies in which they hold shares and act as agents for their beneficiaries, these investors have to responsibly and carefully exercise their votes in the interest of their beneficiaries and with a view towards long-term value generation.¹² In selecting a proxy advisor, institutional investors need to keep in mind that proxy advisors do differ in their policies and processes. Empirically, the correlation of recommendations among the various proxy advisors is rather low (see, for example, Wagner and Wenk (2014) for the case of Switzerland).

¹⁰ The European Best Practice Principles Group (“BPPG”), an association of European and international proxy advisors, is using the term “provider of shareholder voting research and analysis” instead of proxy advisor to accommodate the different legal system of continental Europe. For the sake of readability and consistency with international research, we continue to use the term proxy advisor, considering it as synonym for the official term used by BPPG.

¹¹ See Bethel and Gillan (2002), Cai, Garner and Walkling (2009), and Ertimur, Ferri and Oesch (2013) for studies showing results for ISS and Glass-Lewis recommendations. Wagner and Wenk (2014) document results for Switzerland covering four proxy advisors. Choi, Fisch, and Kahan (2010) caution that the relation between votes and recommendations is not necessarily causal.

¹² Iliev and Lowry (2015) show that actively voting mutual funds, that is, funds that are not exclusively relying on advice from one of the dominant proxy advisor firms (ISS), earn higher risk-adjusted returns.



SWIPRA is aware of the fact that the proxy advisory industry as a whole is facing some concerns about their role. Some researchers have argued that, with institutional investors sometimes not valuing the quality of voting recommendations, certain proxy advisors have developed a tendency to „one-size-fits-all“ approaches and to seek out additional streams of revenue, including asset management and corporate governance consulting services, that negatively affect their **neutrality**.¹³ At the same time, increased competition can help to reduce conflicts of interest.¹⁴ Other researchers instead do not find indications for a „one-size-fits-all“-approach of ISS and Glass-Lewis.¹⁵ Independent of the extent to which these concerns about the neutrality and processes applied by proxy advisors in fact accurately reflect reality, what they show is that proxy advisors also need to earn the trust of issuers and investors.

For these reasons, SWIPRA takes great care to provide an *objective reasoning* behind its recommendations, with each specific recommendation drawing on the SWIPRA policy considerations laid out in this document. We are mindful of the consequences of both “yes” and “no” recommendations and we do not make any recommendation just to “make a point”. Moreover, through the dialogue with companies in view of the upcoming AGM – which is transparently disclosed in the detailed reports – as well as by engaging through the year SWIPRA generally obtains a better understanding of issues deemed critical and provides issuers an opportunity to supplement their arguments in view of an upcoming AGM. Finally, SWIPRA believes and understands that some changes in corporate governance take time and cannot be implemented or addressed fully within the short window prior to a given annual general meeting. Therefore, SWIPRA has a dynamic view and follows up with companies on such longer-term issues, carefully considering implemented changes over time.

6 Legal framework

The primary legal sources relevant for items shareholders can vote on at AGMs are the Swiss Code of Obligations and the Ordinance against Excessive Compensation (OaEC). Moreover, the SIX Swiss Exchange’s Directive on Information relating to Corporate Governance provides guidance and requirements regarding disclosure. In addition, there are also aspects of soft law, in particular the Swiss Code of Best Practice for Corporate Governance issued by *economiesuisse* (2014). This document does not compare the Swiss Code’s recommendations against SWIPRA’s policy considerations.

In the full version of the SWIPRA Policy Considerations, SWIPRA briefly summarizes the current legal framework that is relevant for the respective topic that flows from these sources. On the company level, especially since the adoption of the OaEC, a number of issues need to be governed by the articles of association (henceforth articles).

¹³ See, for example, Belinfanti (2010), Gow et al. (2013), Larcker, McCall and Ormazabal (2015).

¹⁴ See Li (2014).

¹⁵ See, for example, Ertimur, Ferri und Oesch (2013).



In November 2016, a draft revision of the Swiss Code of Obligations was released by the Swiss government. This draft brings about a number of proposed changes (including rules regarding disclosure and explanations on female quotas in boards and executive management; a mandatory vote on the remuneration report for prospective compensation votes; as well as some overall minor changes to the OaEC [which will be formally inserted into the Code of Obligations]). It is too early to speculate on what out of the government's legislative project will actually become part of the law. Also, it is unlikely that the new law would come into effect soon. SWIPRA actively participates in ongoing expert discussions during the legislative process, carefully monitors the development and will adjust its Policy Considerations if deemed necessary.