



## **SWIPRA Position Paper on the Implementation of the Ordinance Against Excessive Compensation: "Say-on-Pay" in Swiss Listed Companies and the Exercise of Voting Rights by Pension Funds**

### **Executive Summary**

This paper states SWIPRA's current view on some of the most significant changes brought about by the entry into force of the Ordinance Against Excessive Compensation ("Ordinance") as of January 1, 2014.

Among the key changes introduced are (1) a trio of provisions governing shareholder participation in the process of setting compensation for members of the board of directors ("Board") and executive management, including (a) an annual binding "say-on-pay" vote by shareholders on compensation (defined as an amount), (b) a vote on compensation principles set out in the Articles of Incorporation ("Articles"), and (c) the election of the members of the compensation committee as well as (2) specific requirements for pension funds to cast their votes.

### ***Say-on-Pay***

While the Ordinance does not require that companies have binding "say-on-pay" votes and submit the corresponding changes to the Articles to the shareholders before the Annual General Meeting ("AGM") 2015, SWIPRA believes that many companies may well decide to adopt all or some of the amendments to the Articles mandated by the Ordinance already at the AGM 2014.

As for (1a) the design of the annual vote on remuneration amounts, SWIPRA advises that companies weigh carefully the advantages and disadvantages of available mechanisms. Importantly, the design of the process of say-on-pay cannot be separated from the design of the compensation system itself. Therefore, "one solution does not fit all" also applies to the choice of the concrete "say-on-pay" mechanism. Proper incentivization, an opportunity to retain talent, and an effective way for shareholders to express their views on the compensation system, the concrete payouts, and the alignment of compensation with performance in the long-term interest of shareholders ("pay for performance") need to be guaranteed.

One approach that could meet all of SWIPRA's key criteria for a good compensation system combines a prospective vote on a maximum total amount (often referred to as a "cap" or – though misleadingly – a "budget") with a retrospective advisory (non-binding) vote on the compensation report. When choosing this system, companies need to be aware of the trade-off they face: On the one hand, they can attain predictability and legal certainty; on the other hand, caps can lead to distorted incentives. In evaluating the cap proposed, SWIPRA will assess the transparency of the compensation system and the extent to which the system is geared towards fostering long-term value generation. The detailed Position Paper discusses additional issues related to the role of "additional amounts" for incoming executive managers and other topics.



Another mechanism is a prospective vote on a cap, covering some parts of the total compensation (e.g., long-term incentive payments), combined with a retrospective binding vote, covering the other parts of the compensation (e.g., short-term incentive payments). While SWIPRA recognizes that retrospective binding "say-on-pay" offers the most direct form for shareholders to express their views on the link between pay and performance, SWIPRA cautions companies against the potentially severe distortionary effects of this approach and the potential loss of predictability of the compensation system.

As for (1b) the compensation principles in the Articles, SWIPRA is of the opinion that, despite their usually broad focus, the principles laid down in the Articles could play an important role in the alignment of the interests of shareholders and management. As a general rule, companies should at least state the fundamental principles and aims of their compensation policy in the Articles. In addition, disclosure on the company's compensation system for the management and the Board in the compensation report will be important to SWIPRA in order to assess accountability and comprehensibility of compensation proposals for both retrospective and prospective votes to be taken.

As for (1c) the compensation committee, SWIPRA will pay close attention to its composition. SWIPRA will assess the expertise and qualification of all candidates for the compensation committee as well as their independence.

On all voting recommendation decisions, SWIPRA will take guidance from its Policy Considerations that reflect state-of-the art economic and legal research regarding value-based management and long-term shareholder value generation, but as well analyze individual companies' situations.

### **Pension Funds**

Art. 22 and 23 of the Ordinance impose a number of obligations on pension funds ("*Vorsorgeeinrichtungen*") that are subject to the Vested Benefits Act of 1993 (*Bundesgesetz über die Freizügigkeit in der beruflichen Alters-, Hinterlassenen- und Invalidenvorsorge*). According to art. 22 of the Ordinance, pension funds shall cast their votes at the AGM on certain items and shall, more generally, vote in alignment with the interest of their insured ("*im Interesse ihrer Versicherten*"). Pension funds may abstain from voting if the interest of their insured requires it. Pension funds shall report on their discharge of those obligations.

SWIPRA's general position is that votes be cast for all investments (whether direct or indirect), as this appears to be the only way to act fully in the interest of the insured or the invested persons. SWIPRA does not perceive vote-casting on select agenda items only (election of the members of the board of directors and the compensation committee) as allowed by the Ordinance to be in line with the overall interests of the insured (even though this is legal).



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## **I The Ordinance Against Excessive Compensation and this Position Paper**

On November 20, 2013, the Swiss Federal Council published the Ordinance Against Excessive Compensation (*Verordnung gegen übermässige Vergütungen, VegüV*). The Ordinance implements the March 3, 2013, constitutional amendment (art. 95 para. 3 of the Swiss Federal Constitution) regarding excessive compensation, following the approval by the Swiss people and the cantons of the so-called "Rip-off-Initiative" or "Minder-Initiative".

The Ordinance covers a broad range of issues. The core element arguably is "say-on-pay." A second key feature is an increased responsibility of pension funds, which SWIPRA believes, at least over the long term, to prove very important as well. This SWIPRA Position Paper deals with these two issues. Requirements for pension funds are discussed in Section II. "Say-on-Pay" is discussed in Sections III to VI.

Moreover, the Ordinance contains, among other topics, provisions regarding elections to the Board, electronic voting at the AGM as well as proxy voting through independent shareholder representatives. SWIPRA will, at a later stage, comment on the implementation of other provisions of the Ordinance.

SWIPRA, when commenting on the implementation of the Ordinance by the companies, will abide by its Policy Considerations, which emphasize value-based management and long-term shareholder value generation, with a view to enhancing transparency vis-à-vis shareholders and ascertaining the unfettered exercise of the shareholders' voting rights.

By expressing its views, SWIPRA does not provide legal advice or advocate one particular position where there are conflicting views from a legal perspective.

## **II Requirements for Pension Funds: Exercising Voting Rights**

### **1 Legal requirements**

Art. 22 and 23 of the Ordinance impose a number of obligations on those pension funds ("*Vorsorgeeinrichtungen*") that are subject to the Vested Benefits Act 1993 (*Bundesgesetz über die Freizügigkeit in der beruflichen Alters-, Hinterlassenen- und Invalidenvorsorge*). According to art. 22 of the Ordinance, pension funds shall cast their votes at the AGM on certain items and shall, more generally, vote in alignment with the interest of their insured ("*im Interesse ihrer Versicherten*"). Pension funds may abstain from voting if the interest of their insured requires it. Pension funds shall report on their discharge of those obligations.

According to the Federal Office of Justice's Additional Report on the Draft Ordinance Against Excessive Compensation (*Entwurf zur Verordnung gegen übermässige Vergütungen bei börsenkotierten Aktiengesellschaften [VegüV]. Zusatzbericht*, dated October 8, 2013; the "Additional Report"), p. 12, said



obligations are to be understood to extend to shares held indirectly, with *e.g.*, an investment fund acting as intermediary, if the pension fund has been granted the right to vote.

## 2 Casting votes

**Casting votes as the standard.** SWIPRA notes that, even under the rules becoming law on January 1, 2014, no legal obligation on pension funds will exist to acquire, at all costs, the right to vote from their intermediary. However, international developments and developments in soft law (*e.g.*, the "Guidelines for institutional investors governing the exercising of participation rights in public limited companies", edited by, among others, Economiesuisse) indicate the formation of a consensus that institutional investors such as pension funds should, as a general rule, cast their votes or ensure that votes are being cast. SWIPRA shares this consensus view.

**Direct and indirect investments.** SWIPRA takes the position that safeguarding the interests of the insured (or the invested persons more generally) should be the overall principle guiding the voting policies of pension funds (or institutional investors more generally). This means that votes should be cast whenever it is in the best interest of the ultimate beneficial share owners, independently of whether investments are held directly or indirectly. And importantly in general, SWIPRA believes that casting votes will be possible in the spirit of the Ordinance also for indirectly held investments. Therefore, SWIPRA believes that pension funds with indirect investments should make reasonable efforts to get the intermediary to vote in their interest while implementing a system allowing the pension fund to influence votes indirectly through the intermediary. To ensure the pension fund's compliance with the Ordinance, the intermediary should also provide the pension fund with a reporting on the voting behavior, at least for debatable agenda items.

**All agenda items and abstentions.** SWIPRA is aware of the limited scope of the pension funds' legal obligation to cast their votes (art. 22 para. 2 of the Ordinance). It is, however, not comprehensible for SWIPRA why casting votes can – in the overall interest of the insured / invested persons – be limited to a few select agenda items. Apart from casting votes for the election of members of the Board and the Compensation Committee and on compensation, other items such as payout and capital structures are equally important in terms of long-term shareholder value. SWIPRA considers that, pension funds, at least when invested directly, will have to assess the items on the agenda of the respective companies anyway. Therefore, voting and reporting on all items rather than only on those required by the Ordinance would in many instances be possible without much additional burden and be in the best interest of the insured and invested persons.

General abstentions are not in the best interest of the insured or the invested persons. This is true regardless of whether the pension fund casts an abstention vote – which will count as a "No" in most companies – or actually abstains from taking part in the AGM.



### III General Remarks on "Say-on-Pay" Elements in the Ordinance

The new constitutional amendment (art. 95 para. 3) and the Ordinance contains three elements that broadly speak to "say-on-pay":

- (i) a binding "say-on-pay" vote (that is, "say-on-pay" in the narrow sense); see Section IV of this Position Paper;
- (ii) the principles of performance-based compensation and share plans in the Articles; see Section V of this Position Paper;
- (iii) the constitution and obligations of the Compensation Committee; see Section VI of this Position Paper.

While the Ordinance does not require that companies have binding "say-on-pay" votes and submit the corresponding changes to the Articles to the shareholders before the AGM 2015, SWIPRA believes that many companies may well decide to adopt all or some of the amendments to the Articles mandated by the Ordinance already at the AGM 2014.

### IV Implementation of the "Say-on-Pay" Vote

#### 1 Legal requirements

The Ordinance does not mandate what exactly the shareholders' meeting has to vote upon. It leaves great leeway to companies as to how they implement "say-on-pay" in their Articles. The Ordinance limits itself to stating three basic principles that all companies must comply with:

- (i) an annual vote by the shareholders' meeting;
- (ii) separate votes on the total amount paid to the Board, to the management, and to the advisory board (*Beirat*), respectively;
- (iii) a binding vote (as opposed to an advisory, non-binding vote).

Draft rules that are currently discussed typically describe the compensation system and opt for one of the following two solutions for management: (i) binding approval of the total maximum compensation for the next business year, or another future period ("prospective cap") or (ii) prospective vote on a cap, covering some parts of the total compensation (*e.g.*, base salary, amounts for payments or grants under long-term incentive plans "LTIP"), combined with a retrospective binding vote, covering the other parts of the compensation (*e.g.*, amounts for payments or grants under short-term incentive plans "STIP", and



sometimes also amounts for payments or grants under an LTIP). See for an analysis of these solutions below.

## 2 Criteria for an effective "say-on-pay" voting mechanism

SWIPRA argues that an effective "say-on-pay" system should, apart from meeting the legal requirements, fulfill the following criteria:

- (a) allow proper incentives with little uncertainty (regarding the terms of "payment for performance") to management,
- (b) keep the company an attractive employer, and
- (c) allow shareholders to meaningfully express their views on the system, the concrete payouts, and the alignment with performance in the long-term interest of shareholders ("pay for performance").

Importantly, the design of the process of "say-on-pay" cannot be separated from the design of the compensation system itself. Therefore, "one size does not fit all" also applies to the choice of the concrete "say-on-pay" mechanism. Thus, within the stated parameters, there are a number of possible mechanisms SWIPRA considers as potentially aligned with long-term shareholder value generation.

## 3 Board of Directors

Most Board members only receive fixed compensation (sometimes partially paid out in shares). For them, SWIPRA's preferred mechanism typically is that shareholders decide prospectively and in a binding manner on the compensation until the next AGM or on the compensation for the next business year starting after the AGM (*e.g.*, vote on compensation for the business year 2015 at the AGM 2014). Figure 1 illustrates the respective timing (FY stands for financial year. For example, the AGM held in March 2016 is labeled AGM FY15 because it refers to the financial year 2015).

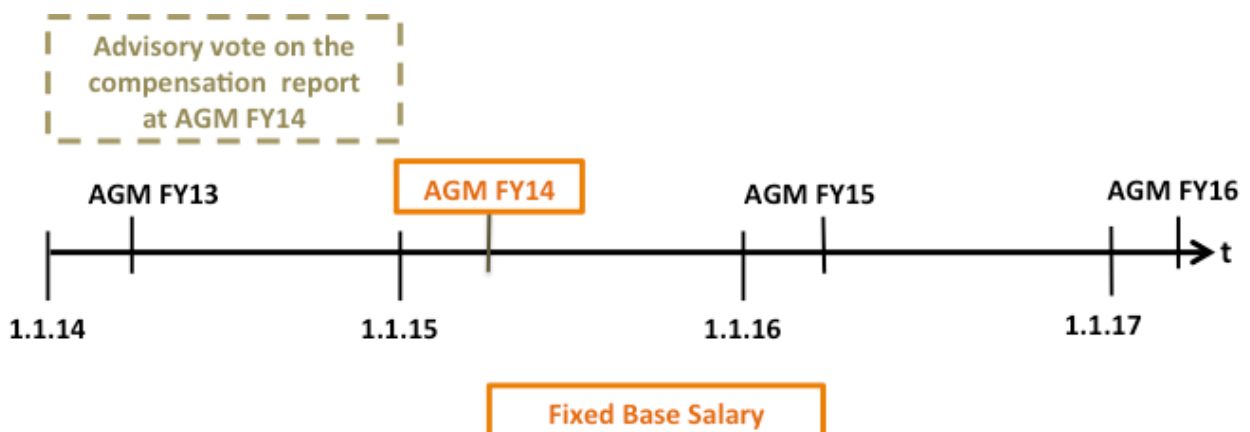


Figure 1: Voting on pay of members of the Board of Directors

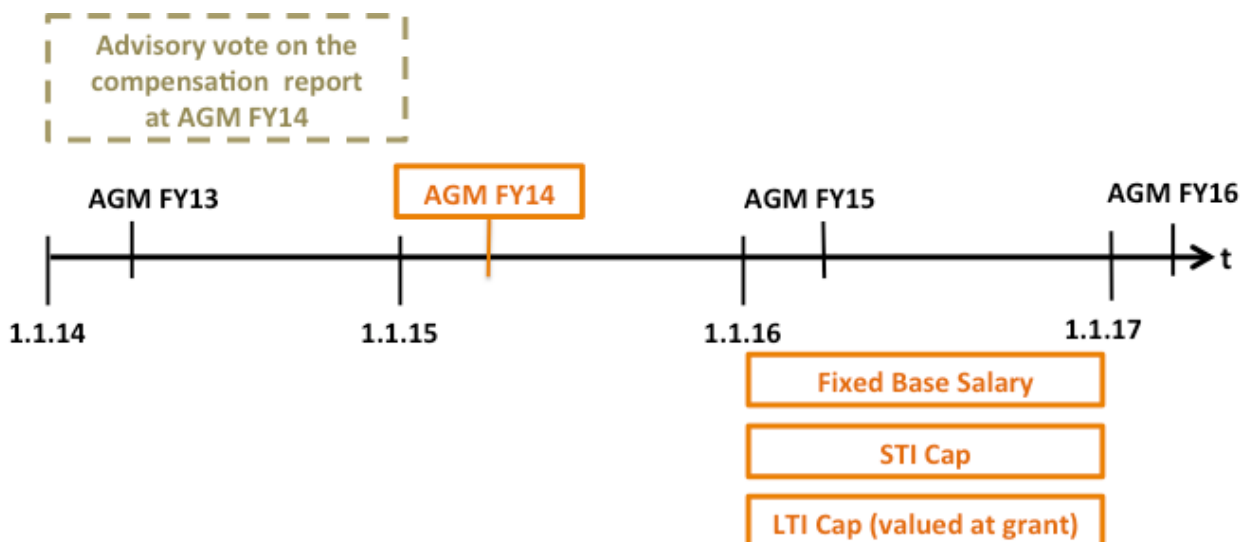


For Board members whose compensation also consists of performance-based elements, one may, in principle, apply the considerations set out below with regard to compensation of the executive management. It should be noted, however, that Board members must stand for re-election on a yearly basis. As the overall level of legal certainty for Board members is, *a priori*, more limited, arguments relating to legal certainty will carry less weight than they do in the context of management compensation.

#### 4 Executive Management

##### a) Binding vote on a prospective cap combined with an advisory retrospective vote on the compensation report

A voting mechanism potentially meeting all of the above criteria is a system which combines a prospective vote on a maximum total amount (often referred to as a "cap" or – though misleadingly – a "budget") with a retrospective advisory vote on the compensation report. Under such a system, shareholders would, *e.g.*, approve at the AGM 2015 in a binding manner the maximum total amount for management compensation for the business year 2016. At the AGM 2017, shareholders would then give their views on the reasonableness of the Board's use of the amount approved by the AGM 2015 – which will largely depend, at least for the short-term incentive (STI) programs, on the business performance in 2016. This timing is illustrated in Figure 2.



**Figure 2: Binding vote on a prospective cap amount combined with an advisory retrospective vote on the compensation report (LTI: amount for long-term incentive, typically related to an equity-based plan; STI: amount for short-term incentive)**





SWIPRA notes that true prospective voting requires voting on the cap amount for next business year, rather than on the current business year. As AGMs are generally held in spring or early summer time, a vote on the ongoing year does not ensure the full motivational effect of performance-based pay. In fact, the vote would become partially a retrospective vote. Moreover, voting on the current financial year does not provide the necessary legal certainty the Board and new hires need when they sign contracts before the AGM.

**Advantages of prospective caps.** Prospective voting on a cap amount offers the advantage of a high degree of certainty for management with respect to the potential pay from the incentives that are in place. It also gives shareholders a forward-looking insight into what the expected costs of executive compensation could be. Payment or grant amounts under long-term incentive plans (LTIP) would need to be valued at grant. The actual costs to shareholders could be higher or lower than the disclosed value, but the costs will be higher only if indeed business performance would have been better.

**Disadvantages of prospective caps.** Companies should keep in mind that caps are not without problems. One challenge is that high cap amounts can be difficult to communicate. Conversely, if the cap is set too low, this will lead to a severe distortion of incentives. In particular, there may be a risk that executives will, once having reached their performance objectives and therefore the portion of the cap that should be attributed to them, try to save the results for the next period. Thus, on purely economic grounds, SWIPRA would not generally advocate for caps on executive remuneration, however, under the new Rules, this is a consequence of opting for prospective voting.

**Determining the appropriateness of a prospective cap.** If the Articles contain a cap on the short-term incentive program and the long-term incentive program, the cap can generally be calculated as a factor of the base salary. This, in turn, requires that the shareholders know at least approximately what total base salary is intended for the next business year.

If the Articles do not contain caps on incentive plans, the decision can be more difficult. Shareholders can reasonably vote on the proposed cap only on the basis of sufficient information. Such information is generally provided through (i) the compensation principles in the Articles, (ii) the compensation system explained in the Compensation Report, (iii) the outlook contained in the Compensation Report, and (iv) the information provided by the Board in the invitation to the AGM.

When evaluating proposed caps, SWIPRA will look at all information available when assessing whether the cap appears to be in line with the company's principles etc. regarding compensation and, specifically, the long-term interest of shareholders. In making this evaluation, SWIPRA will draw on its Policy Considerations (see also Section V.3 of this Position Paper). SWIPRA will tend to be critical of a proposed cap if the information contained in the compensation principles and the description of the compensation system are insufficient or unintelligible or – even if the information provided is sufficient and if the compensation principles and system are in line with SWIPRA's Policy Considerations – should the arguments provided for the proposed cap in fact fail to rationally support the proposal. In assessing the



rationality of the Board's proposal, SWIPRA will, among other things, take into account the company's past compensation practices and the amounts paid in the past; consistency with these practices and amounts will generally weigh in favor of the Board's proposal.

**The role of the retrospective advisory vote.** The retrospective advisory vote (*e.g.*, based on the 2015 Compensation Report at the AGM 2016) allows shareholders to express their views on whether the Board has adhered to the company's compensation principles and its compensation system and on how it has used its discretion, if any, in granting remuneration, *i.e.*, if it paid for performance.

While the retrospective advisory vote in itself is non-binding, it may still be meaningful as a disciplinary device which also works *ex ante*. It is essential, however, that shareholders and management alike carefully separate arguments regarding the retrospective vote about the Compensation Report from arguments regarding the prospective vote about the cap.

**Separation of prospective and retrospective votes.** Proposals for compensation relating to different periods must be put to individual votes at the AGM. Thus, prospective and retrospective votes would be held separately. Despite this separation, shareholders who are unhappy with the Compensation Report regarding the past business year may be reluctant to support the Board's proposal for a prospective cap for the next business year. While creating such a link is problematic as a matter of principle, it may have a positive effect on the quality and level of disclosure the Board will provide in the Compensation Report since at the same AGM the Board will want to gain support from the shareholders for the vote on the cap amount.

**Combination or separation of votes on various compensation elements.** For proposals relating to the same period (in particular, the same business year), however, companies may, at their discretion, choose whether to have shareholders' vote on amounts for fixed compensation (salary), long-term incentives, and short-term incentives, each including expected expenses for social security, in a combined vote or in separate votes. SWIPRA is not opposed to the principle of having shareholders vote separately on base compensation, short-term incentives and long-term incentives. What is important is that shareholders obtain a clear view of the overall compensation system in place.

**Information requirements.** Both with respect to the prospective binding vote on the cap and the retrospective advisory vote on the Compensation Report, SWIPRA recognizes that certain information that would be useful for the shareholders may be sensitive or secret. Companies should not be expected to disclose such information, in particular the required degree of actual achievement of the management's key performance indicators (hereinafter referred to as "KPI"). However, SWIPRA recommends that companies clearly explain their compensation systems, in particular any key KPIs that will be used in order to determine the level of short-term incentives or the vesting criteria for long-term incentive plans. Shareholders also deserve insight into how strongly KPIs matter for pay.



**Additional amounts.** According to art. 19 of the Ordinance, a company's Articles may provide, if the shareholders' vote on compensation is prospective, for an "additional amount" ("*Zusatzbetrag*") to be used if the maximum total amount approved by the shareholders should prove insufficient to compensate executives hired after the AGM.

The additional amount should also be sufficient to enable the continuation of the management of the company under adverse circumstances where immediate replacements or additions would become necessary. The amount must be expressed either as an absolute number or in relation to the maximum total amount approved at the AGM for executive remuneration, for it must be "determined or determinable" ("*bestimmt oder bestimmbar*") according to the Additional Report, p. 11. According to art. 19 para. 3 of the Ordinance, the additional amount, once it has been laid down in the company's Articles, shall not be put to the vote of the AGM. However, information about the additional amount should form part of the remuneration report. As a result, what is put to the vote of the AGM – namely, the cap – will not have to be inflated to make provision for the possibility of newly appointed managers.

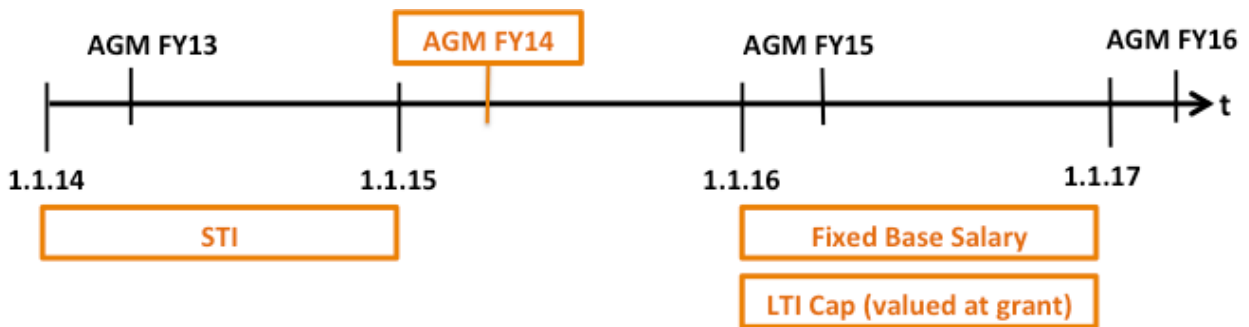
When assessing the proposed size of this "additional amount", SWIPRA will take into consideration the information provided by the company on the principles determining the amount (such as pre-defined percentages of compensation attributed to certain functions within management, *e.g.*, 40% of the CEO's annual maximum compensation).

**b) Binding vote on a prospective cap on some compensation elements combined with a binding retrospective vote on other compensation elements**

Under this system, shown schematically in Figure 3, the following timing applies: Part of the compensation, for instance the fixed base salary, is approved prospectively (*e.g.*, at the AGM 2015, the base salary for the business year 2016 is approved in a binding manner). By contrast, all or some of variable pay is voted on in a binding fashion retrospectively.

A reasonable combination of a binding prospective vote and a binding retrospective vote would be to have prospective voting on the fixed base salary and on the LTI amount (typically related to an equity-based plan) and retrospective voting on the STI amount. Thus, an STI "promised" for performance in the business year 2014 would be approved at the AGM in spring 2015 and would only be paid out if the shareholders agree on the aggregate amount planned to be paid out or granted. A retrospective vote on the LTI would be, in SWIPRA's view, a less appropriate mechanism. This would tend to frame LTI grants as rewards for past performance when in fact these grants should incentivize management for the future.

Two separate votes would have to be held for the prospective and the retrospective votes.



**Figure 3: An example of a binding vote on a prospective cap amount combined with a binding retrospective vote (LTI: amount for long-term incentive; STI: amount for short-term incentive)**

**Advantages of retrospective binding votes.** Subjecting all or part of variable pay to a retrospective vote allows shareholders to decide 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. Further, the total amounts are likely to be lower in the aftermath than when having to fix a cap well ahead.

**Disadvantages of retrospective binding votes.** One of the concerns is that incentivizing management by variable compensation geared to reaching certain performance criteria (KPI) will be difficult in case shareholders could – even if such KPI's are 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. This issue is even more pronounced when the STI payment is made with the discretion of the Board and is thus geared towards rewarding extra-contractual efforts. Economic theory and empirical studies have demonstrated the potentially fatal effects of the so-called "hold-up" problem. Managers who fear that their efforts in the current business year will not be rewarded at the AGM in the following year have severely distorted incentives that can lead to value-destroying decisions. In a company dominated by large shareholders, compensation promises made by the Board are more likely to retain their incentivizing effect, as the shareholders' meeting will approve the compensation. In this specific case, the "hold-up" problem may not be as pronounced. The consequences of a binding retrospective vote could also weaken the position of this company in the employment market for executives. Maintaining the company's standing as an attractive employer may necessitate an increase in fixed compensation.

In addition, a negative retrospective vote at the AGM causes much more severe legal problems than a negative vote on a prospective cap, in particular if the period which the prospective vote refers to is the next rather than the current business year. If the shareholders do not approve the prospective cap submitted to them, contracts with managers are affected by the negative vote only with respect to the



portion of their compensation owed for the next business year. This leaves companies at least some time to cure the situation. A negative retrospective vote, however, puts into question part of the compensation owed for management's performance in the past.

All of these concerns regarding retrospective votes weigh much less heavily if the vote is non-binding.

### c) Performance periods and compensation voting periods

The ordinance allows for basically any one-year period as the basis for a vote on compensation. However, for reasons of transparency and viability, SWIPRA in general argues that compensation periods – in particular when a retrospective vote (whether binding or advisory) takes place that needs to take into account performance measures – should be aligned with business years. This way, shareholders can make decisions based on audited financial information, rather than on interim financial results.

Evaluating the performance of management for example from mid-year to mid-year, but voting on their compensation in the spring may lead to severe distortions: If the vote is of a prospective kind, management receives the incentive to report more cautiously for the AGM (in order to set the performance goal for the upcoming year lower) and more aggressively in mid-year (in order to maximize payout). If the vote is of a retrospective kind, the time elapsed between end-of-evaluation period (mid-year) and the AGM can be very long, potentially leading shareholders to punish management for current economic downturns that are independent from their achievement in the evaluation period. Figure 4 shows the votes in relation to voting periods running from mid-year to mid-year.

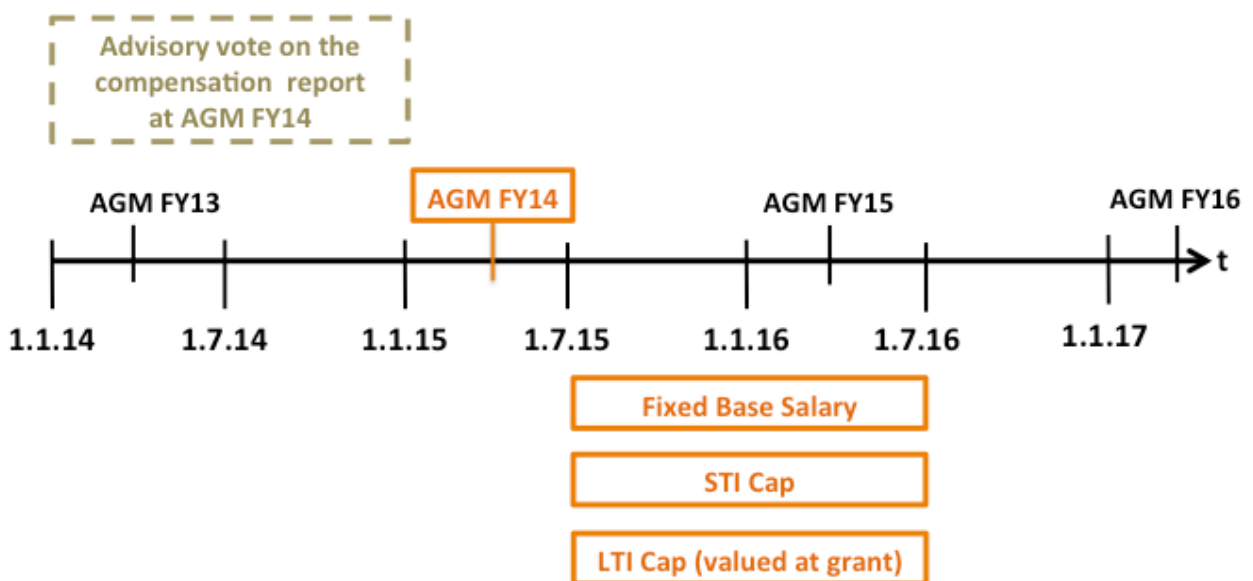


Figure 4: Prospective cap at mid-year



## V Compensation Principles in the Articles and Compensation Report

### 1 Compensation Principles in the Articles

The second element of "Say-on-Pay", broadly defined, is that the Ordinance requires the companies to lay down in their Articles the principles governing performance-based compensation and the grant of shares, options, etc. under equity participation plans.

**Role of the compensation principles.** The principles laid down in the Articles can play an important role in the alignment of the interests of shareholders and management.

For the purposes of (a) allowing proper incentivization with little uncertainty (about the terms of "payment for performance") to management and (b) keeping the company an attractive employer, it is important that the shareholders commit themselves to the company's compensation principles, either by voting in favor of the clauses in the Articles containing the company's compensation principles or by investing in a company that has made its compensation principles patent in its Articles. These principles may safeguard against "rogue shareholders." They may also serve as a "focal point" for executives and shareholders, thus increasing the level of mutual trust and facilitating efficient collaboration. Finally, they may also ease negotiations between the company and potential future executives: While the vote at the AGM is a factor of uncertainty in such negotiations, the principles enshrined in the Articles provide to the potential executive at least some firm commitment from the company, however vague and broadly defined these principles may be.

**Striking a balance between detail and flexibility.** SWIPRA recognizes that companies face an important trade-off. On the one hand, if the wording of the compensation principles is more detailed, it will be easier to determine whether proposals for compensation at the AGM are in line with the principles stated in the Articles, which, at this stage, would already have been assessed by SWIPRA. Also, as mentioned in the paragraph before, making the company a reliable employer who fulfills its contractual promises regarding compensation is an argument in favor of more detailed provisions in the Articles, since the Articles are binding upon the shareholders' meeting. On the other hand, the more detailed such compensation principles will be laid out, the less discretionary incentive components would be possible. However, companies will need to accept more transparency to be the price for the prospective cap-principle.

From SWIPRA's point of view, the compensation principles in the Articles are to be seen in connection with the information provided in the Compensation Report as well as the explanations by the board of directors in the invitation to the AGM. Vague compensation principles and vague provisions regarding the grant of shares etc. may be compensated, at least from a transparency perspective, by more detailed information in the Compensation Report. It is the overall information that will allow or not allow the shareholders to cast their votes on an educated basis.



## **2 Compensation Report**

The purpose of the Compensation Report is for the Board to account for the use of any amount approved by the shareholders prospectively and the use of the additional amount, as defined in the Articles. The Compensation Report should explain whether and why the Board considers its use of these amounts to be in line with the compensation principles in the Articles and the compensation system described in the previous Reports.

## **3 Compensation Principles and SWIPRA's Policy Considerations**

When evaluating a company's Articles and deciding on how to vote on its Compensation Report, SWIPRA will take guidance from its Policy Considerations. Hence, it is worth restating some of the basic principles underlying SWIPRA's Policy Considerations.

### **a) One solution does not fit all**

The overarching principle of SWIPRA's recommendations is that the compensation system has to be a best fit with the company's business strategy. SWIPRA does not pretend to know what the optimal compensation systems and levels are for the companies on which it provides voting recommendations. The evaluation of the compensation principles laid down in the Articles and the Compensation Reports therefore primarily focuses on the process-level (how pay is set) and very generally on whether it can be expected that the compensation scheme will lead to value generation for long-term shareholders.

### **b) Pay should be for (sustainable) performance**

SWIPRA will be more likely to recommend voting for compensation principles in the Articles and for Compensation Reports if there is evidence that the system in place establishes pay for sustainable performance. SWIPRA endorses compensation systems that display a clear future (forward-looking) and actual (realized in the past) link of performance targets to the company's specific value-drivers, while making sure that any KPI's used strike a balance between being controllable and being too easily and directly influenceable by management.

SWIPRA in general will look favorably at incentive systems that ensure an entrepreneurial drive at the top of organizations and that encourage executives to take risk responsibly, *i.e.*, for the benefit of their shareholders. Naturally, there need to be safeguards such as sufficiently long and gradual vesting periods and possibly claw-backs, and strong governance needs to avoid excessive risk-taking when, for example, stock options are used.

### **c) Compensation policy should be accountable**

Any compensation policy should contribute to attracting and retaining suitable executives and to incentivizing incumbent executives. However, whether a given pay package is considered appropriate or



inappropriate (including whether the amounts being paid are appropriate or inappropriate) cannot be judged absent a reference point regarding what the company is trying to achieve.

Therefore, SWIPRA recommends that Compensation Reports contain a general section that describes the company's compensation policy. To ensure the transparency and defensibility of both the compensation system and the concrete amounts paid to directors and management, it is imperative that companies describe in the Report the process by which pay is set. SWIPRA understands that in some circumstances, it may not be possible to disclose all details of the underlying performance measures, because of potential competitive disadvantages. However, companies should whenever possible compare actual achievement of executives to each performance target, disclosing how each performance target affected compensation.

SWIPRA's view is that incentive plans should include a subjective component. A suitably composed and competent Compensation Committee can and should decide to reward actions of the management team that maybe have yet to materialize in the performance measures used or in the share price. Conversely, the Board or the Compensation Committee should be able to impose penalties when management implemented inappropriate actions – including actions inconsistent with ethical practices or the company's Code of Conduct and actions that are harmful to others. If a purely formulaic approach is used, SWIPRA wishes to see evidence that the company takes measures to ensure that unforeseeable contingencies do not severely impair the functioning of the incentive system.

Compensation policies must be consistently applied. Ex-post changes of performance criteria, for example, are generally indicative of either poor ex-ante design or poor ex-post governance. In turn, changes to the degree of achievement required in order to earn a certain portion of variable pay may in some circumstances be well justified.

**d) "It's not only how you pay, but also how much"**

SWIPRA is of the view that "it's not only how you pay, but also how much." There are no absolute pay thresholds that would lead SWIPRA to recommend voting against a system, but the higher the compensation is relative to a firm's size and industry, the more intense SWIPRA's scrutiny of the features of the system will in general be.

Among other factors, SWIPRA recognizes that the trust society has in a company can be eroded by excessive pay policies, and that a company can ultimately only generate value for its long-term shareholders if it is seen as being in "good standing." Therefore, even if in a narrowly defined model in which society, customers, and other stakeholders do not directly play a role, a particular pay structure may be optimal, it is possible that the public outrage constraint would still bind for the company, making a different pay structure preferable. Board members and executives should be sensitive to "headline risk."





## **VI Compensation Committee**

SWIPRA will pay attention to the composition of the Compensation Committee. Members of the Compensation Committee should have experience in the field of compensation and/or in corporate governance. SWIPRA will assess the expertise and qualification of all candidates for a seat on the Compensation Committee.

It is particularly important that Compensation Committee members (and the full Board) have time to reflect on any major compensation issue. Shareholders have a right to know from the Compensation Report whether the Compensation Committee members spent enough time to this topic.

The Compensation Committee can be combined with the corporate governance committee and/or the nomination committee. In general, SWIPRA takes the position that the organization of the Board and its committees is company-specific. In any event, SWIPRA is looking for an indication in the Compensation Report on how the Compensation Committee informs the entire Board and how, therefore, the overall responsibility of the Board with respect to compensation in particular is ensured.

While not required by any binding legal provision in Swiss law, SWIPRA, in accordance with the Swiss Code of Best Practice for Corporate Governance (appendix from 2007), stipulates that no executive board member should be part of the Compensation Committee, in order to allow an unbiased and independent process. The Compensation Report must disclose whether members of the Board and executive management, about whose compensation and share-ownership programs a decision is being taken by the competent body, have the right to attend the relevant meetings of that body as well as a right to take part in the decisions. SWIPRA recommends that such attendance and voting rights not be granted. At the very least, there must be parts of the Compensation Committee sessions that are held without executive management present.