economiesuisse

English version

swiss code of best practice for corporate governance

economiesuisse
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Five years after it was first approved, the "Swiss Code of Best Practice for Corporate Governance" can be said to be a success: the self-regulation system functions properly while allowing companies the necessary room for manoeuvre. This is also an important factor in Switzerland's success as an international centre of commerce.

The issue of remuneration for directors and executives has given rise to frequent and often heated discussion. This prompted economiesuisse to provide supplementary recommendations aimed at introducing more objectivity into the debate. At its meeting on 6 September 2007, the Board of Directors of economiesuisse approved an Appendix to the "Swiss Code of Best Practice for Corporate Governance" with ten recommendations on the remuneration of directors and senior managers. Self-regulation is being reinforced further. With its decision, the Board has taken due account of the responses received through the consultation process.

The new Appendix is part of the "Swiss Code" and is based on the self-regulation principle. It provides companies with recommendations on structuring the remuneration system as well as information that goes beyond what is stipulated by law. At the same time, however, companies retain their flexibility.

Gerold Bührer
Chairman of the Board

Dr. Pascal Gentinetta
Chairman of the Executive Board

Content

Supporting Organizations

The following organizations, which give high priority to corporate governance in their activities, have expressly agreed to adopt the "Swiss Code" and Appendix 1:

	Date on which declaration of support was issued "Swiss Code"	Appendix 1
ASIP Swiss Association of Pension Funds, Zurich	25.04.2002	12.12.2007
ethos – Swiss Foundation for Sustainable Development, Geneva	29.04.2002	10.10.2007
Swiss Banking Swiss Bankers' Association, Basel	22.04.2002	23.10.2007
SGCI Chemie Pharma Schweiz, Zurich	6.06.2002	15.10.2007
Swiss Employers Association, Zurich	29.04.2002	1.10.2007
Schweizerischer Gewerbeverband (Swiss Union of Crafts and SMEs), Berne	19.04.2002	10.12.2007
SVV Swiss Insurance Association, Zurich	8.05.2002	16.10.2007
Swissmem (The Swiss Mechanical and Electrical Engineering Industries), Zurich	16.04.2002	17.11.2007
Swiss Institute of Certified Accountants and Tax Consultants, Zurich	8.04.2002	6.12.2007
The Swiss Association of Privately Held Companies, Basel	17.04.2002	18.12.2007
Federation of Industrial and Service Groups in Switzerland, Berne	25.04.2002	15.10.2007

Other organizations are also free to submit a declaration of support. They will be updated immediately in electronic publications and the next editions of the printed versions. All adopting organizations will be involved in the further development of the "Swiss Code".

Members of the working group that drafted the texts:
— **Prof. Peter Böckli**, Lawyer and author of the Code
— **Dr Thomas Hodler**, Secretary, Swiss Re
— **Prof. Karl Hofstetter**, University of Zurich, Member of the Board of Directors of Schindler Holding – author of the analysis report
— **Stefan Lüchinger**, SWX Swiss Exchange, Head of Publicity**
— **Richard T. Meier**, SWX Swiss Exchange, Project Manager for Corporate Governance guidelines*
— **Thomas Pletscher**, Member of the Board of Directors of economiesuisse and head of the panel of experts
— **Christian Stiefel** (lawyer), Secretariat, Federation of Swiss International Holding Companies
— **Dr Thomas Staehelin**, President of the Swiss Association of Privately Held Companies**
— **Beatrice Fischer**, Managing Director, Credit Suisse Group, Zurich (representing Dr Urs Rohner, COO und General Counsel, Credit Suisse, Zurich)**

* "Swiss Code" only
** Appendix 1 only

The work was monitored by the extended panel of experts on Corporate Governance. This is made up both of representatives of economiesuisse's members and those of adopting organizations.

The "Swiss Code of Best Practice for Corporate Governance" (hereinafter "Swiss Code") and Appendix 1 were adopted by the management board of economiesuisse on 25 March 2002 and on 6 September 2007 respectively. The working group had sole responsibility for compiling the Comments on the Appendix.

Swiss Code of Best Practice for Corporate Governance

2.1 Preamble

1 Since economiesuisse is the federation of Swiss businesses from all sectors of the economy (industry, financial sector, other services), it is the appropriate private sector institution to establish the principles of corporate governance in Switzerland.

In the light of international discussions and on the initiative of interested circles, economiesuisse entrusted a "Corporate Governance" Panel of Experts at the beginning of 2001 with the task of unifying the different efforts to codifiy all the various aspects of corporate governance in Switzerland. Pre-existing models form a reliable basis for the "Swiss Code", first and foremost those from Great Britain (*"Cadbury Report"* 1992, *"Hampel Report"* 1998 and the *"Combined Code",* which is compulsory for all companies listed in London). Further text proposals are based on models from a number of other countries such as France *(Rapport Viénot)* and recently Germany (the corporate governance study of July 2001 by the *"Baum Commission"* appointed by the Federal Chancellor and the *"German Corporate Governance Code"* published in February 2002).

2 The *"Swiss Code"* addresses the situation in Switzerland with its characteristic mixture of large, medium and small companies. Here, despite all the criticism, there has been a gradually perceptible improvement in corporate practices since the revision of the Company Law, which came into effect on 1st July 1992. The conceptual principles of this law differ from German and Anglo-Saxon company laws. The "Swiss Code" will comprehensively embody the high standard of practices which – with some well-known exceptions – are now being widely observed by many exemplary companies in Switzerland. At a time when capital markets are being linked worldwide the "Swiss Code" will give mainly foreign investors an idea of what has been achieved and what is anticipated in corporate governance practices.

3 The "Swiss Code" is intended as recommendations for *Swiss public limited companies. Non-listed* economically significant companies or organizations (also in other legal forms) should be able to develop appropriate guidelines from the "Swiss Code".

4 Each of the participating *organizations* should be free to emphasize the importance of different aspects and pursue its own ideas in the development of the "Swiss Code", even departing where necessary from its core aspects.

5 The question of *capital structure* and particularly the principle of *"one share – one vote"* requested by investors are not part of the "Swiss Code". The reasons for this decision are set forth in the analysis report "Corporate Governance in Switzerland" by Professor Karl Hofstetter and discussed in detail by the Panel of Experts. According to the guidelines of SWX Swiss Exchange, however, each restriction on the proportional capital voting rights is subject to *disclosure.*

6 As in other countries, corporate governance in Switzerland is *governed by current Swiss law.* Some foreign criticism shows that certain peculiarities of Swiss company and stock exchange law have not been sufficiently taken into consideration. The separate report *"Corporate Governance in Switzerland"*, written by Professor Hofstetter in collaboration with the Working Group, analyses the major points of criticism and the provisions of currently applicable Swiss Law. This report deals especially with the current state of the *Swiss stock exchange and take-over law* (notification threshold, public offers, threshold for compulsory offering, opting out, ad hoc publicity, half year reports, accounting standards, etc.). Most of these aspects have a connection with corporate governance as well but cannot, or can only to some extent, be the object of recommendations of a *"Code of Best Practice"*. The "Swiss Code" presented here should be understood in the light of this analysis.

2.2 Swiss Code of Best Practice for Corporate Governance

"Corporate Governance" as a guiding principle
Corporate governance encompasses the full range of principles directed towards shareholders' interest seeking a good balance between direction and control and transparency at the top company level while maintaining decision-making capacity and efficiency.

The "Swiss Code of Best Practice for Corporate Governance" as a guideline and recommendation
The "Swiss Code of Best Practice for Corporate Governance" ("Swiss Code") is intended for public limited companies. Certain provisions are addressed to institutional investors and intermediaries. The purpose of the "Swiss Code" is to set out guidelines and recommendations, but not force Swiss companies into a straightjacket. Each company should retain the possibility of putting its own ideas on structuring and organization into practice.

I Shareholders

1 As investors, shareholders have the final decision within the company.

— The powers of the shareholders are defined by statute. They alone are entitled to make decisions with regard to personnel matters at the top company level (electing and granting release to members of the Board of Directors and appointing the company's auditors), the final approval of accounts (annual and consolidated financial statements) and policy on distributions and shareholders' equity (dividends, increase in capital or reduction of capital). The shareholders determine in the Articles of Association the purpose of the company and other key elements and rules. Their approval is required for decisions on mergers, demergers, changes in the Articles of Association and liquidation.

— Shareholders exercise their rights in the General Shareholders' Meeting and have the right to make motions on items prescribed by the agenda. They may also request information on company matters not included in the agenda and, if appropriate, a special audit.

— Institutional investors, nominees and other intermediaries exercising shareholders' rights in their own name should ensure, as far as possible, that beneficial owners may exercise their influence as to how such shareholders' rights are brought to bear.

— Where registered shares are acquired through custodian banks, the latter should invite the party acquiring the shares to apply for registration in the company's Register of Shareholders.

2 The company should endeavour to facilitate the exercise of shareholders' statutory rights.

— To this end the Articles of Association may lower to an appropriate degree the statutory threshold for shareholders to place items on the agenda or to convene an Extraordinary General Shareholders' Meeting.

— If the General Shareholders' Meeting reduces the par value of shares through repayment, the Board of Directors should review whether it would be appropriate to adjust the required threshold (relating to requests to place items on the agenda, convene meetings or, where appropriate, for a special audit to be carried out) to ensure that shareholders' rights are not curtailed.

— The Articles of Association should be available in writing or in electronic form at any time.

3 The company should ensure that the General Shareholders' Meeting is used as a forum for communication so that it is well-informed in discharging its function as the highest corporate authority.

— The Board of Directors should inform the shareholders in such a way that they can exercise their rights in the knowledge of the essential basis of their decisions.

— The company should, when convening meetings, provide concise explanations on agenda items and on motions put forward by the Board of Directors. Requests by shareholders to place items on the agenda and motions made by them should, if received in time, be officially communicated.

4 **The company should facilitate the participation of shareholders at General Shareholders' Meetings by clearly setting dates and time limits well in advance.**

— The Board of Directors should give notice of the date of the next ordinary General Meeting as early as possible.

— The company should give notice of the deadline for shareholders to propose items for the agenda as well as corresponding motions. This date should not be set any further in advance of the meeting's date than necessary.

— If the Board of Directors sets a deadline prior to the General Meeting in order to identify the persons entitled to exercise shareholders' rights, this deadline, both for holders of registered and of bearer shares, should ordinarily be no more than a few days before the date of the meeting.

5 **The organization of the meeting should enable shareholders to make relevant and concise comments on the agenda items.**

— The Chairman should use his[1] powers to ensure that shareholders may exercise their rights. He should conduct the meeting in a balanced and purposefully way.

— In the interest of the efficient running of the meeting the Chairman should take care that there be no rambling, repeated or unnecessarily derogatory statements. He may limit the time allotted to each speaker, if there are numerous requests to speak on the same agenda item.

6 **Arrangements should be made to ensure that shareholders' rights to information and inspection are met.**

— The Chairman should answer questions which are in order and relate to the company or arrange for a competent specialist or the Chairmen of the Board Committees to reply.

— Complex questions or those having a number of different aspects should be submitted to the Board of Directors in writing in sufficient time to allow for a response to be prepared.

— The minutes of the meeting should be made available to the shareholders as soon as possible but not later than three weeks after the meeting's date.

[1] Terms which indicate a particular gender are intended to denote either gender.

7 In the General Shareholders' Meeting the will of the majority should be clearly and fairly expressed.

- The Chairman should implement the voting procedures in such a way that the majority will can be determined in as an unambiguous and efficient a way as possible.
- In the absence of a clear majority, the Chairman should arrange for voting to take place by written or electronic ballot. If voting takes place by a show of hands, shareholders may request votes against the motion and any abstentions to be recorded. The number of such votes cast should be communicated to the meeting.
- The Chairman may arrange for a combined poll to be taken when electing members of corporate bodies or granting release to them, provided no opposition from the shareholders is apparent and there is not a request for a separate vote on one or more individuals.

8 The Board of Directors should also take steps to contact shareholders in between the General Shareholders' Meetings.

- The Board of Directors should inform shareholders on the progress of the company also during the course of the financial year.
- The Board of Directors should appoint a position for shareholders relations. In the dissemination of information, the statutory principle of equal treatment should be respected.

II Board of Directors and Executive Management

a Functions of the Board of Directors

9 The Board of Directors, which elected by the shareholders, is responsible for the strategic direction of the company or the group.

— The Board of Directors should determine the strategic goals, the general ways and means to achieve them and the individuals charged with management.

— In its planning it should ensure the fundamental harmonization of strategy and finances.

10 Swiss company law lays down the inalienable and non-transferable primary functions of the Board of Directors.

— The primary functions are:

1. the ultimate direction of the company and the giving of the necessary directives;
2. the establishment of the organization;
3. the structuring of the accounting system and of the financial controls as well as financial planning, insofar as necessary to manage the company;
4. the appointment and removal of the persons entrusted with the management and representation of the company;
5. the ultimate supervision of the persons entrusted with the management, with regard, in particular, to compliance with the law, the Articles of Association, regulations and directives;
6. the preparation of the annual report as well as the preparation of the general shareholders' meeting and the implementation of its resolutions;
7. the notification of the court in case of an excess of indebtness over assets. (Art. 716a [1] Swiss Code of Obligations).

11 Subject to the provisions of the Articles of Association the Board of Directors should lay down the powers and responsibilities of the persons in charge of managing the business.

— The Board of Directors should ensure that management and control functions are allocated appropriately.

— If the Board of Directors delegates management responsibilities to a Managing Director or to a separate Executive Board, it should issue organizational regulations with a clear definition of the scope of the powers conferred. As a rule it should reserve to itself the power to approve certain significant business transactions.

b Composition

12 A well-balanced membership of the Board of Directors should be sought for.

- The Board of Directors should be small enough in numbers for efficient decision-making and large enough for its members to contribute experience and knowledge from different fields and to allocate management and control functions (section 21 ff.) among themselves. The size of the Board should match the needs of the individual company.
- Members of the Board of Directors should be persons with the abilities necessary to ensure an independent decision-making process in a critical exchange of ideas with the Executive Management.
- The majority of the Board should, as a rule, be composed of members who do not perform any line management function within the company (non-executive members).
- If a significant part of the company's operations is abroad, the Board of Directors should also include members having long-standing international experience or members from abroad.

13 The Board of Directors should plan for the succession of its members and ensure that members receive continuing education.

- The ordinary term of office for members of the Board of Directors should, as a rule, not exceed four years. Adequately staggered terms of office are desirable.
- The Board of Directors should plan the succession of its members and lay down the criteria for selecting candidates.
- The Board of Directors should ensure that newly elected members receive appropriate introduction and that Board Members, where required, receive further training with respect to their responsibilities.

c Procedures and Chairmanship of the Board of Directors

14 The Board of Directors should determine the procedures appropriate to perform its function.

- The Board of Directors should, as a rule, meet at least four times a year according to the requirements of the company. The Chairman should ensure that deliberations are held at short notice whenever necessary.
- The Board of Directors should review regulations it has issued at regular intervals and amend them as required.
- The Board of Directors may obtain at the company's expense independent advice from external experts on important business matters.
- The Board of Directors should discuss annually its own and its members' performance.

15 **The Chairman is responsible for the preparation and conduct of meetings; the providing of appropriate information is one of his core responsibilities.**

— The Chairman is entrusted with conducting the Board of Directors in the company's interest. He should ensure that procedures relating to preparatory work, deliberation, passing resolutions and implementation of decisions are carried out properly.

— The Chairman should ensure in mutual cooperation with the Executive Management that information is made available in good time on all aspects of the company relevant for decision-making and supervision. The Board of Directors should receive, as far as possible prior to the meeting, the well presented and clearly organized documentation; if that is not possible, the Chairman should make the documentation available prior to the meeting allowing, sufficient time for perusal.

— As a rule persons responsible for a particular business should be present at the meeting. Anyone who is indispensable for answering questions in greater depth should be available.

d Dealing with conflicts of interest and advance information

16 **Each member of the Board of Directors and Executive Board should arrange his personal and business affairs so as to avoid, as far as possible, conflicts of interest with the company.**

— Should a conflict of interest arise, the member of the Board of Directors or Executive Management concerned should inform the Chairman of the Board. The Chairman, or Vice-Chairman, should request a decision by the Board of Directors which reflects the seriousness of the conflict of interest. The Board shall decide without participation of the person concerned.

— Anyone who has interests in conflict with the company or is obligated to represent such interests on behalf of third parties should not participate to that extent in decision-making. Anyone having a permanent conflict of interest should not be a member of the Board of Directors or the Executive Management.

— Transactions between the company and members of corporate bodies or related persons should be carried out "at arm's length" and should be approved without participation of the party concerned. If necessary, a neutral opinion should be obtained.

17 **The Board of Directors should regulate the principles governing ad hoc publicity in more detail and take measures to prevent insider-dealing offences.**

— The Board of Directors should consider in particular whether appropriate action (e.g. "close periods") should be taken with regard to purchasing and selling securities of the company or other sensitive assets during critical periods, e.g. in connection with take-over projects, before media conferences or prior to announcing corporate results.

e Chairman of the Board of Directors and President of the Executive Management: joint or separate function

18 The principle of maintaining a balance between direction and control should also apply to the top of the company.

— The Board of Directors should determine whether a single person (with joint responsibility) or two persons (with separate responsibility) should be appointed to the Chair of the Board of Directors and the top position of the Executive Management (Managing Director, President of the Executive Board or Chief Executive Officer).

— If, for reasons specific to the company or because the circumstances relating to availability of senior management makes it appropriate, the Board of Directors decides that a single individual should assume joint responsibility at the top of the company, it should provide for adequate control mechanisms. The Board of Directors may appoint an experienced non-executive member ("lead director") to perform this task. Such person should be entitled to convene on his own and chair meetings of the Board when necessary.

f Internal control system dealing with risk and compliance

19 The Board of Directors should provide for systems for internal control and risk management suitable for the company.

— The internal control system should be geared to the size, the complexity and risk profile of the company.

— The internal control system should, depending on the specific nature of the company, also cover risk management. The latter should apply to both financial and operational risks.

— The company should set up an Internal Audit function which should report to the Audit Committee or, as the case may be, to the Chairman of the Board.

20 The Board of Directors should take measures to ensure compliance with applicable rules.

— The Board of Directors should arrange the function of compliance according to the specific nature of the company. It may also allocate compliance to the internal control system.

— The Board of Directors should review at least once a year whether the principles of compliance applicable to themselves and the company are sufficiently known and are constantly observed.

g Committees of the Board of Directors

21 **The Board of Directors should form committees to perform defined tasks.**

- The Board of Directors should appoint committees from amongst its members responsible for carrying out an in-depth analysis of specific business related or personnel matters for the full Board in preparation for passing resolutions or exercising its supervisory function.
- The Board of Directors should appoint the members as well as the Chairman of each committee and determine its procedures. Otherwise, the rules applying to the Board of Directors should apply accordingly to the committees.
- The Board may combine the functions of several committees provided that all their members fulfil the respective qualifications.
- The committees should report to the Board of Directors on their activities and findings. The overall responsibility for duties delegated to the committees remains with the Board of Directors.

22 **As regards committee members, particular rules on independence should be applied.**

- It is recommended that a majority of the members of certain committees be independent. Independent members shall mean non-executive members of the Board of Directors who never were or were more than three years ago a member of the executive management and who have no or comparatively minor business relations with the company.
- Where there is a cross membership in Boards of Directors, the independence of the respective member should be carefully examined case by case.
- The Board of Directors may lay down further criteria of independence.

Audit Committee

23 **The Board of Directors should set up an Audit Committee.**

- The Committee should consist of non-executive, preferably independent members of the Board of Directors.
- A majority of members, including the Chairman, should be financially literate.

24 **The Audit Committee should form an independent judgement of the quality of the external auditors, the internal control system and the annual financial statements.**

- The Audit Committee should form an impression of the effectiveness of the external audit (the statutory auditors or, if applicable, the group auditors), and the internal audit as well as of their mutual cooperation.
- The Audit Committee should additionally assess the quality of the internal control system, including risk management and should have an appreciation of the state of compliance with norms within the company.

- The Audit Committee should review the individual and consolidated financial statements as well as the interim statements intended for publication. It should discuss these with the Chief Financial Officer and the head of the internal audit and, separately, should the occasion warrant, with the head of the external audit.
- The Audit Committee should decide whether the individual and consolidated financial statements be recommended to the Board of Directors for presentation to the General Shareholders' Meeting.
- The Audit Committee should assess the performance and the fees charged by the external auditors and ascertain their independence. It should examine compatibility of the auditing responsibilities with any consulting mandates.

Compensation Committee

25 **The Board of Directors should set up a Compensation Committee.[2]**

- A majority of the Compensation Committee should consist of non-executive and independent members of the Board of Directors.
- The Chairman of the Board respectively the President of the Executive Management should, as a rule, be consulted except when their own remuneration is under review.
- The Compensation Committee should draw up the principles for remuneration of members of the Board of Directors and the Executive Management and submit them to the Board of Directors for approval.

26 **The Committee should see to the defining of a remuneration policy, primarily at top company level.**

- The Compensation Committee should take care that the company offers an overall package of remuneration, which corresponds to performance and the market, in order to attract and retain persons with the necessary skills and character.
- The remuneration should be demonstrably contingent upon sustainable company success and the individual contribution by the person in question. False incentives should be avoided.
- The dilution effect caused by share option schemes for senior managers should be minimized and the conditions for exercising options shall not be modified subsequently in favour of the option holders.
- Contracts of employment with top managers should contain such provisions on termination of employment as are commensurate with market conditions and which protect the company's interest. In case of early termination of a top management contract only such severance compensation should be paid which is either owed due to the contract or which has been negotiated in compatibility with the interests of the company.

[2] Appendix 1 provides for stricter rules in terms of independence (see p. 22).

Nomination Committee

27 **The Boards of Directors should set up a Nomination Committee.**

— The Nomination Committee should lay down the principles for the selection of candidates for election or re-election to the Board of Directors and prepare a selection of candidates in accordance with these criteria.

— The Nomination Committee may also be assigned responsibilities in connection with the selection and assessment of candidates for top management.

h Particular circumstances

28 **The rules contained in this Code may be adapted to actual circumstances, depending on the shareholder structure and size of the company.**

— Companies with active major shareholders (including subsidiaries listed on the stock exchange) as well as small and medium-sized enterprises may adapt or simplify the guidelines. Such companies should implement in their own way an appropriate arrangement for the assessment of the external audit, a functionally efficient internal control system, the remuneration policy for members of the Board of Directors and the Executive Management and the succession policy for the Board of Directors.

— Small and medium-sized companies may assign responsibilities to individuals instead of setting up committees or have the full Board of Directors perform these tasks.

III Auditing

29 **The function of the external audit is performed by the statutory auditors elected by the shareholders and, should that be the case, the group auditors.**

— The external auditors should discharge the functions assigned to them in accordance with the guidelines relevant to them. They should cooperate in an appropriate way with those in charge of internal auditing.

— Auditors and group auditors should comply with the guidelines on maintaining independence applicable to them.

IV Disclosure

30 **The company should disclose information on Corporate Governance in its annual report.**

— The SWX Swiss Exchange Directive on information relating to Corporate Governance is applicable with regard to detailed disclosures.

Appendix 1

Introduction

In the five years that have elapsed since the publication of the *"Swiss Code of Best Practice for Corporate Governance"* by economiesuisse and the Corporate Governance Directive by the SWX Swiss Exchange, questions surrounding the compensation of Boards of Directors and senior managers of public companies have become the focus of attention. This has manifested itself in a number of developments:

— As an advance part of the ongoing revision of company law in Switzerland, the new articles 663b^{bis} and 663c para. 3 of the "Swiss Code" of Obligations have entered into force. Above and beyond the Corporate Governance Directive, these require details of remuneration and loans to members of the governing bodies of listed companies to be published, in addition to any participation rights these members hold. All aspects of this issue are to be audited in the future by auditors;

— A law has been in effect in the United Kingdom since 2002 which provides for a consultative vote by shareholders on the compensation report of the Board of Directors. In other countries too, this type of solution to involve shareholders has either been adopted or is under discussion;

— Political initiatives in Switzerland – including parliamentary measures and a popular initiative that is still at the signature phase (the so-called "Minder" initiative) – address the issue of compensation for the governing bodies of public companies;

— Both in the US and in the EU, legal initiatives have been implemented or are being prepared which aim to increase transparency of compensation to members of governing bodies, and which for the most part expand the remit of the Shareholders' Meeting by giving it a say in the matter.

This is sufficient reason for once again reviewing the recommendations set out in *paras. 25 and 26* of the *"Swiss Code"* (on compensation committees and compensation policy) and reflecting on the corresponding suggestions put forward in the report by Prof. Karl Hofstetter. [1] *Para. 26* of the *"Swiss Code"* does actually already set out some key principles of a compensation policy that would work in the interests of shareholders and companies alike, and these retain their validity. There is, however, evidence of a need to make these principles more concrete and to develop them further in the light of experience gained over the last five years. This is treated in the following Appendix to the *"Swiss Code"*.

[1] Karl Hofstetter, "Fünf Jahre Swiss Code of Best Practice. Sonderbericht zur Frage der Entschädigung von Verwaltungsrat und Management in Publikumsgesellschaften" [Five Years of the Swiss Code of Best Practice – Special Report on the Issue of Compensation for Boards of Directors and Senior Managers in Public Companies]. Zurich 2007. www.swissholdings.ch

Recommendations on compensation for board of directors and executive board

The *Appendix 1* set out here clarifies and expands the provisions of *paras. 25 and 26* of the *"Swiss Code of Best Practice for Corporate Governance"* with updated recommendations on the issue of compensation for members of Boards of Directors and Executive Boards. This *Appendix 1* is considered an integral part of the *"Swiss Code"*, and takes precedence over the text of March 25, 2002 insofar as any differences exist, particularly with respect to requirements for the *independence* of members of compensation committees (hereinafter Para. 2).

Appendix 1 to the *"Swiss Code"* can offer neither binding regulations nor a generally applicable formula for resolving questions arising in conjunction with compensation to members of Boards of Directors and Executive Boards in public companies. It should, however, set out recommendations for responsible treatment of these issues that have now become a focus of socio-political discussion – and are likely to remain so for some time.

Of key importance here is the need to stress that it is for business and companies to assume responsibility. Given the context of a liberal economic system, the aim cannot be to issue regulations governing the type and extent of compensation that should apply for Boards of Directors and senior managers. The task of corporate governance provisions should be to draw attention to guidelines and ensure transparent procedures which are free of conflicts of interest and geared to market realities. The way in which compensation is determined for senior managers and Boards of Directors must be comprehensible to shareholders. The endeavours undertaken by Boards of Directors will ultimately prove crucial in ensuring that the compensation levels that apply to directors and senior managers find acceptance among the wider public, and also of course among the employees of the companies in question.

a The Compensation Committee of the Board of Directors and its role

1 The Board of Directors passes a resolution on the compensation system and determines the responsibilities of the Compensation Committee.

- The Board of Directors passes a resolution on the design of the compensation system for members of the Board of Directors and the Executive Board, as well as on guidelines for the design of retirement benefits for the executive members of both bodies.
- Furthermore the Board of Directors sets out the extent to which a Compensation Committee is assigned full resolution authority, the authority to make decisions subject to ratification by the body as a whole, or authority to submit proposals. In doing so the Board of Directors generally reserves the right to approve the overall compensation for the Executive Board and the compensation of the Chief Executive Officer.
- The Compensation Committee keeps the Board of Directors abreast of its deliberations during the latter's meetings, and reports to it at least once a year in detail on the development of the compensation process and the Committee's experience; where necessary it proposes the requisite changes to the compensation system.

2 **Only independent members of the Board of Directors sit on the Compensation Committee.**

- The Compensation Committee appointed by the Board of Directors must not include any members with interlinked company mandates. Such a situation is deemed to exist if a committee member responsible for co-determining the compensation of a member of the Board of Directors or member of the Executive Board is himself/herself subject to the supervisory or directive powers of a member in another company.
- Independent members of the Board of Directors who are themselves, or represent, significant shareholders may be members of the Compensation Committee.

b The compensation system

3 **The Compensation Committee is entrusted with the task of developing a proposal for the structuring of a compensation system for the top executives and board members of the company according to the directives of the Board of Directors.**

- The Board of Directors instructs the Compensation Committee on the basic elements of the compensation system for members of the Board of Directors and the Executive Board; this system should be simple, clear and reproducible.
- The company offers overall compensation commensurate with market conditions and aligned to performance in order to acquire and retain individuals with the necessary skills and character.
- The compensation system is designed in such a way that the interests of senior managers are aligned with the interests of the company.
- The Committee also strives to ensure reproducibility with respect to the practical application of the compensation system.

4 **As a rule, the compensation system contains both fixed and variable components; it rewards conduct aimed at medium- and long-term corporate success with compensation elements available at a later date.**

- Where the compensation system consists of both fixed and variable elements for individuals in executive positions, it should be structured in such a way that the variable component is in reasonable relation to individual performance on one hand, and sustainable success of the company or of a corporate unit on the other.
- The assessment of the variable compensation component is based on reproducible criteria; leadership qualities less easy to measure should also be taken into account. The variable compensation elements are cancelled or reduced if the relevant targets are not met.
- The Board of Directors determines whether or not share-based compensation is awarded as well. In this case the Board considers the different effects of allocating shares on the one hand and options or similar instruments on the other.
- Where share based compensation is concerned, the Committee ensures the timeliness of such compensation. As a rule, it tailors the immediately available elements of the compensation package to the attainment of short-term targets;

elements of the compensation package dependent upon the attainment of medium- or longer-term goals should be vested or blocked for a number of years.

5 The compensation system is structured in such a way as to avoid the allocation of advantages not objectively justifiable or false incentives.

— The Compensation Committee takes care to ensure that the system does not set any unintended incentives or contain any components that could be influenced counter to their objectives.

— When drawing up employment contracts with members of the Executive Board, any unusually long notice periods or contract durations are to be avoided except in specific situations.

— Options on shares of the company are granted with a strike set at the same level or preferably higher than the average market value in question over a determined number of trading days prior to the day of granting.

6 As a principle, the company does not grant "golden parachutes" or severance compensation.

— As a principle, the compensation system rules out any "golden parachute" arrangements applying in the event of a change in the company's control, as well as any severance applying in the case of termination of an employment contract at any other time ("special benefits"). Not considered as special benefits in this sense are:

a benefits arising from provisions which – in the event of a change of control – permit eligible persons early vesting of deferred vested shares, options or other rights with due consideration of the principle of equal treatment, and

b the standard processing of existing obligations (including bonus payments envisaged by the compensation system) in the event of a termination while under contract.

— Special benefits granted in the event of a change in the company's control or other circumstances can only be justified if they are in the company's interests, and if they represent remuneration for exceptional services to the company for which the individual in question has not already been compensated in some other form. If the Board of Directors exceptionally provides for a special benefit in advance, it does so under this condition.

— The company discloses any special benefit that is agreed or awarded to cover the case of a change in company control or the premature departure of a member of the Board of Directors or Executive Board.

7 The Compensation Committee scrutinizes salary comparisons with other companies as well as the work of external and internal consultants.

— Where the remuneration practices of other companies serve as a comparative yardstick, the Committee undertakes a critical review of the composition of this peer group and of the conclusiveness of the comparisons drawn for its own compensation. It excludes from the peer group any companies that would skew the comparative results, either because of a lack of corporate governance or for any other valid reason.

— If the Committee brings in external consultants to make comparisons and recommendations in the area of senior executive compensation, the Committee itself decides on the consultant to use, issues the mandate, and determines the fee. It evaluates the results critically.

— If the Committee orders comparisons to be undertaken by the staff of its own company, these staff must be subject to the instructions of the Committee Chairman.

c Role of the Shareholders' Meeting

8 The Board of Directors produces a compensation report for the Shareholders' Meeting annually.

— The compensation report describes the compensation system and its application in the business year under review. It illustrates also in tabular form, how the system has impacted the value terms over the period under report for individual Board members, the overall Board of Directors, the Executive Board as a whole, and the latter's most highly-remunerated member.

— The report shows the key criteria that have been used in measuring the variable elements of remuneration, and the mechanism that has been applied for valuing shares and share options according to the relevant rule system.

— The compensation report specifies the external consultants that have been used in connection with compensation issues and describes the comparisons that have been made.

9 The Board of Directors involves the Shareholders' Meeting in the debate on the compensation system in an appropriate form.

— The Board of Directors decides how to involve the Shareholders' Meeting in the debate on the compensation system.

— As a rule, it selects one of the following options:

Option 1
The compensation report is brought into the discussion during the agenda items. *Approval of the Annual Financial Statements or Discharge to Board of Directors.* The Chairman of the Board or the Chairman of the Compensation Committee comments on the compensation report as well as the compensation system and then answers any questions. The resolution to approve the annual financial statements and the resolution of discharge are taken by the shareholders in knowledge of the details provided in the compensation report and the comments of the Chairman of the Compensation Committee.

Option 2
The Board of Directors puts the *compensation report* – which provides information on the compensation system adopted by the Board Directors and sets out in more detail the compensation awarded to senior executives in the business year in question – *to a consultative vote* at the Shareholders' Meeting.

d Transparency

10 The Board of Directors ensures transparency with respect to the compensation of the members of the Board of Directors and the Executive Board.

- The Board of Directors ensures that the compensation report sets out the company's compensation system in a manner that is readily comprehensible.
- The compensation report is structured so as to make clear in particular which compensation payments have been awarded to the members of the Board of Directors, the Executive Board overall, and the latter's highest-paid member for the business year and why these compensation payments have either fallen or risen in the business year.
- The Board of Directors may issue the compensation report separately, as part of the annual report, or as part of the corporate governance report.
- As details on remuneration and loans to members of the Board of Directors and the Executive Board must appear in the appendix for legal reasons, they may simply be mentioned by means of a reference in the compensation report if the details are not considered of importance to the report's statements.

Comments on the Appendix 1

What prompted the preparation of an Appendix to the "Swiss Code of Best Practice for Corporate Governance"?

Karl Hofstetter's report entitled "Five Years of the Swiss Code of Best Practice – Special Report on the Issue of Compensation for Boards of Directors and Senior Managers in Public Companies", Zurich 2007,[1] demonstrated, among other things, that

- the *Swiss Code* of 25 March 2002 has proved its worth in most areas and can continue to provide the recommended guidelines for Swiss public companies in the absence of any major or pressing changes;
- since the Code's introduction, Switzerland has become a leader in the field of corporate governance;
- developments over the past five years nevertheless make it advisable to review and augment the recommendations made in 2002 in respect of *compensation* for members of the Board of Directors and the Executive Board.

economiesuisse therefore requested the Working Group (which now has two additional members) that drew up the *Swiss Code* in 2001 to draft a new appendix to it based on the findings of the *Hofstetter II* report.[2]

As stated in the introduction to the draft version of "*Appendix I, Recommendations on Compensation for Board of Directors and Executive Board*", stricter requirements in respect of the *independence* of members of compensation committees have made it necessary to amend the text approved on 25 March 2002. The *Swiss Code* remains in force in its entirety, notably *paras. 25 and 26* relating to compensation committees.

1 www.swissholdings.ch

2 Prof. Peter Böckli, Dr Thomas Hodler, Prof Karl Hofstetter, Stefan Lüchinger, Thomas Pletscher, Christian Stiefel as well as Dr Thomas Staehelin and Beatrice Fischer (standing in for Dr Urs Rohner). Prof. Peter Böckli served as head of the editorial team. Thomas Pletscher evaluated the findings of the consultation process (draft version as amended on 25 June 2007).

Guidelines for supplementing the *Swiss Code* with an appendix on the compensation of directors and senior managers of public companies

In drawing up the new text, which is intended to supplement *paras. 25 and 26* of the "*Swiss Code*" in the light of recent developments, economiesuisse has been guided by the following four principles:

1 Retaining the style of the *Swiss Code* (i.e. using clear, straightforward language and avoiding "legalese" rather than repeating legal provisions, attempting to take the place of a management manual or acting as a "Guide to Corporate Ethics in Practice");
2 *Limiting the new text to a number of principal rules* containing recommendations on the critical points, and elaborating on these rules in a few sections;
3 *No "binding" rules* but some carefully targeted statements of opinion instead;
4 Ensuring the greatest possible *room for manoeuvre for individual companies*; the latter should assume complete responsibility for their own actions.

It goes without saying that each of the ten points dealt with below reflects *a broad spectrum of opinions*. There is no unity of outlook among the public companies or even among the individual boards responsible for deciding on the eventual content. *Appendix 1* therefore takes a middle line, as the consultation process carried out in July/August 2007 confirmed. Each company should be entirely free to develop its own basic principles and also to implement different solutions on one or more points – provided there is a cogent internal reason for doing so – without being bound by a "duty to explain".

The consultation process gave rise to considerable comment. The most important observations are as follows:

— All the responses welcomed economiesuisse's initiative, although some also sounded a warning note about over-regulation.
— The proposed increased involvement of the General Meeting gave rise to some controversy. The proposal offering various options (special debate during discussion of the annual report or the discharge to the Board of Directors, consultative vote or other solutions specific to the company) met with a very varied reception, ranging from the rejection of any further involvement on the part of the General Meeting to demands for a compulsory consultative vote.
— The view was expressed that – especially where severance packages are concerned – the decision-making scope of Boards of Directors should not be restricted since this could put them at a disadvantage on the international market for executives. This applies to medium-sized companies in particular. Other members, by contrast, were in favour of a more restrictive formulation of the exceptions – as rare as they may appear in the proposed text.
— A separate compensation report was rejected in various quarters on the grounds that it would simply lead to double-tracking and bureaucracy, while other respondents from all circles expressly welcomed such a report and called for it to contain additional detailed requirements.
— Some members would like to go over to the "*comply or explain*" system (i.e. the obligation either to comply with *Appendix 1* or to provide specific reasons for implementing any solution that deviates from it). However, this obligation was rejected when the *Swiss Code* was first published on 25 March 2002, and it would be difficult for *Appendix 1* to follow a different system from the Code to which it is appended. The majority of those consulted did not take up this point.

a The Compensation Committee of the Board of Directors and its role

Re para. 1 (resolution on the compensation system)
This *principal rule*, set out in greater detail in *section 1*, may appear to be self-evident. In reality, however, it has hitherto been the case that by no means all Boards of Directors have instigated a full debate on how the compensation system is to be set up, including discussion of the various options, and then reached a decision at Board level. In many cases the key features of the system have simply emerged from whatever was the usual practice in previous years, and were never clearly laid down in a resolution.

It is also surprising how often there is no trace of the Board of Directors ever having formulated a resolution on the main guidelines governing *occupational pensions*.

In *substance*, the compensation system is not described in detail in *para. 1* (which deals primarily with the responsibilities of the full Board of Directors), but rather in *paras. 3 to 6*.

In *section 2*, the Board of Directors is called on to set out clearly in what circumstances the Compensation Committee is responsible for drawing up a *proposal*; in what circumstances it has unrestricted and definitive authority – having been delegated the latter within the scope of art. 716b of the Swiss Code of Obligations (OR) – to pass a resolution; and on what points the full Board of Directors reserves the right to *approve* the decision reached by the committee. *Appendix 1* confines itself to enumerating the three types of solution, from which each individual company can select a suitable model appropriate to its particular needs. However, the findings of the consultation process indicate that there is a need for an additional clause which makes clear that *as a rule* the full Board should have the last word with regard to the overall sum of all compensation paid to the Executive Board and its President.

A formal delegation authority should then be included in the company's organizational regulations. This matter also raises legal questions. It is, however, not part of *Appendix 1*'s remit to provide legal advice: instead, it is up to each individual company to decide for itself whether and to what extent it regards it as legally permissible to delegate setting the amount of compensation paid to members of the Executive Board (or the managers reporting to the President of the Executive Board) in the light of art. 716a section 1 para. 4 OR, and if so, whether it wishes to take advantage of the opportunity to transfer the authority to pass such resolutions.

With regard to setting the amount of compensation paid to *members of the Board of Directors itself*, the recommendations contained in *section 1 and section 2* provide for the following: the Board of Directors can *delegate* this matter to the Compensation Committee (which should be composed of independent members of the Board of Directors exclusively) for a *final decision* or, in cases where the Compensation Committee's decision still requires the Board's approval, the decision can be put before the full Board for ratification. However, the *full Board of Directors* can elect to make a decision on this matter, based on a proposal put forward by the Committee (in such a case the Committee has authority to submit motions only in accordance with *section 2 clause 1*). None of these approaches fully solves the basic problem of *self-dealing*. This potential difficulty has however been greatly eased by the provision set out in art. 663b^{bis} OR – in force since 1 January 2007 – requiring that the *individual* compensation packages paid to all members of the Board of Directors *must be disclosed*.

If the President of the Executive Board also sits on the Board of Directors, he must withdraw from any discussion on setting or approving the amount of compensation he is to receive. This follows from para. 16 of the *Swiss Code* and does not need to be repeated here. *Executive members of the Board of Directors* must also withdraw when the full Board is setting the compensation levels for a chief executive (President) or for executive directors. Executive members of the Board of Directors also find themselves faced with a particular conflict of interests when the subject of compensation for the person to whom they report in executive matters (President or Managing Director) is under discussion, in which case – as set out in *para. 16* of the *Swiss Code* – they must withdraw from the debate.

Section 3 seeks to ensure that the Compensation Committee does not lose touch with the *full Board of Directors* regarding the compensation process. In practice reports are quite often submitted in an overly technical and numbers-oriented form, without the experience gained in implementing the compensation system – whether favourable or unfavourable – coming to the attention of the full Board. The recommendation in *Appendix 1* is designed to address this problem.

Re para. 2 (independence)
By definition only *non* executive members of the Board of Directors count as independent according to the *Swiss Code* (and all other such codes throughout the world).

The criteria for *independence* set out in the current *Swiss Code* are tersely formulated but have nevertheless proved workable (*para*. *22*). Each company may introduce stricter criteria if it considers this to be a desirable course of action, particularly in relation to the more stringent requirements of foreign stock exchanges.

Appendix 1 departs from the earlier idea that *the majority only of* the members of the Compensation Committee need be independent. It is now recommended that no one who is an executive or otherwise non independent member of the Board of Directors should be allowed to sit on the Compensation Committee. *Appendix 1* makes clear with reference to the principal rule in *para*. *2* that, given recent trends, the credibility of a *Compensation Committee* is guaranteed only if *all* its members are independent. This has now become the international standard and has been widely adopted in practice.

Appendix 1 then describes in *para*. *1* – still in the form of a recommendation – a particular situation in which a member of the Board of Directors *may not belong to* the Compensation Committee, even though he can in effect be deemed to be *independent* under *para*. *22* of the *Swiss Code*. This approach avoids a more precise definition of the general concept of independence in *Appendix 1*. Instead, a rule is laid down regarding ineligibility for membership of the Compensation Committee.

It is generally regarded as normal practice for the *Chairman of the Board of Directors* not to be a voting member of the Compensation Committee. In most cases a "non full-time" Chairman of the Board will still have to carry out some executive functions and therefore will not count as independent. If he really is independent, however, the company should not prevent him from sitting on the Compensation Committee if it considers this to be desirable. Para. 25 section 2 of the *Swiss Code* will apply in all cases: the Committee can invite the Chairman of the Board to *attend with an advisory vote* – but not, of course, when it is considering the Chairman's own compensation.

Section 2 makes clear that – in deliberate contrast to some views in English-speaking countries – a *significant shareholder* may be a member of the Compensation Committee, provided that he fulfils the standard independence criteria. It is conceivable that a significant shareholder could use his influence as a member of the Compensation Committee to assist a favoured member of management to an inappropriately high level of compensation, but he could still do this without necessarily being a member of the Compensation Committee. Such an abuse is, moreover, likely to be a rare event; as a rule, significant shareholders are primarily motivated by cost-effectiveness when considering questions of compensation.

b The compensation system

The subject heading highlights the transition to the recommendations dealt with in paras. 3 to 6.

Re para. 3 (proposal for the compensation system)
Appendix 1 stresses in *section 1* that the Board of Directors is responsible for specifying the *key elements of the compensation system*. The Committee's task is then to formulate this in concrete terms; it has to create an *architecture* which is balanced and takes due account of the recommendations set out in the Appendix. The work of the Compensation Committee is challenging and requires the members to become thoroughly acquainted with the requirements of the task. It will also become increasingly necessary for the members of the Committee, particularly its Chairman, to undergo specialist training and development.

The whole of *para. 3* refers to the principal rule set out in para. 26 of the *Swiss Code*:

> *"An overall package of remuneration, which corresponds to performance and the market, in order to attract and retain persons with the necessary skills and character."*

This is repeated in the text of the Appendix (*section 2*). Today, the widely used phrase "commensurate with market conditions and individual performance" is being called somewhat into question, with the remark precisely that compensation for top managers in major companies is a sign of *market failure*. The Working Group considered this objection, which emerged during the consultation process, but would like to retain the phrase that appears in the *Swiss Code*. This is because the market failure hypothesis has not yet been adequately proven; it probably applies only to certain sectors which nevertheless obtain wide media coverage.

Section 3: The "*alignment of interest*" principle routinely employed in the English-speaking world to ensure that the compensation system aligns managers' interests with shareholders' interests is inherent in all the recommendations and is also reflected in the "negative recommendations" in *paras. 4, 5 and 6* below. The principle of *alignment of interest* is expressly set out in *section 3*. However, it would be a mistake to assume that the *alignment of interest* principle means that the personal interests of the employees will then *always* match those of the company. On the contrary, there are many situations where a director or top manager is obligated – due to his duty of loyalty – to set his own personal interests firmly aside so that the company's interests prevail. This arises precisely in the case of a change of control, as discussed in para. 6, where loyalty requires the Board of Directors and Executive Board to strive for the best outcome for the company and its shareholders, without regard for their own personal needs.

Great importance is attached to *reproducibility* (*section 4*), not only in relation to the architecture as such, but with particular reference to how the compensation system is actually implemented in any particular financial year.

Re para. 4 (fixed and variable elements, time congruence)
Para. 4 (unlike *paras. 5 and 6*) contains *positive stipulations* as to how an consistent and convincing system of fixed and variable compensation can be structured. It goes without saying that each company is free to decide for itself whether it wishes to build variable remuneration elements into its compensation system.

Setting out the *criteria* for evaluating the variable compensation (*section 2*) is a matter for the company. *Appendix 1* leaves open where and how *performance conditions* are built in and how they are defined. Such conditions – at first sight so convincing in principle – can create counter-incentives in some cases or even turn out to be unfair or glaringly inequitable in practice for the manager concerned.

Section 3 highlights that the characteristics and implications of two compensation elements – *company shares* and *stock options* – are *radically different* for the recipient (and sometimes for the company too).

In applying *para. 4* it seems to be important, that
- *soft factors* (expressed as "*leadership qualities that are rather less easy to assess*") should also be given a role in determining the level of compensation granted. Although the people-skills aspect of management cannot be quantitatively measured, there are methods which use objective criteria to tackle this difficult task;
- variable compensation *should actually be reduced* if the relevant targets are not met (*section 2*);
- the Board of Directors should give sufficient consideration to the *very varied characteristics and implications* of the compensation elements (*section 3*). Rather like payments in kind, an equity allocation is an involuntary investment in company shares that cannot be sold in the medium term – it generally consists of company shares, or options entitling the holder to purchase them, that cannot be sold for several years. A stock option plan (especially stock options with a vesting period) bestows the right to a derivative with highly variable characteristics, strong upward leverage and the risk that its value could be wiped out; it may also be configured in widely differing ways according to the strike price and other specific conditions that are applied. *Shares* and *stock options* can therefore represent completely different types of incentive.

The question of *time congruence* in the compensation system is addressed in *section 4*. This deals with the principle that the achievement of long-term targets is rewarded in the architecture of the compensation system by means of share allocations or share options that accrue over the longer term, while short-term targets are rewarded by means of compensation elements that can be evaluated and accessed in the near term.

The whole of *para. 4* deals with the assessment of the compensation to be distributed to the members of the Board of Directors and the Executive Board. The subsequent change in the value of shares or share options that have already been allocated does not come into this. The assessment process naturally includes a careful analysis of the impact of the selected distribution system – a general responsibility covered by *sections 1 to 4* of *para. 4*, as well as *para. 1 section 1, para. 3* and *para. 5*, and in some cases *para. 6*.

Re para. 5 (avoidance of counter-incentives or bounties that are not objectively justifiable)
Section 1 serves as a reminder that the Compensation Committee must make great efforts to ensure that the system under discussion does not set any unintended counter-incentives or contain any components that could *work against* the stated targets. This – as the first section expressly emphasizes – means checking carefully for unintended effects that could remain hidden at first and produce harmful results later on, when the system is in operation. The Committee must also ensure that the system it has set up is not susceptible to manipulative abuse. If any such state of affairs should arise at a later stage, it must take effective action to remedy the situation.

Sections 2 and 3 give examples of undesirable features of a compensation system for senior executives and directors – again, these are not exhaustive, but rather based on readily understandable cases.

Section 2 contains recommendations discouraging notice periods in excess of 12 months or unusually long contract durations. This could constitute a bounty that is not objectively justifiable or – depending on the situation of the company – a kind of "*golden parachute*" if there should be a change of control. Although the timescales agreed in such arrangements are legally binding on the company as well as the Executive Board member and apply equally to both parties, cases of this nature tend in practice to be settled in one direction only – namely, against the employer in the form of a large sum demanded by the employee as compensation for early termination of employment. *As a rule*, a binding contract lasting more than one or two years is considered to be unusually long – depending on the type of activity and the international environment. Each company remains free to draw up its own policy with due regard to its particular needs and the present recommendations.

In some cases a longer binding contract can be in the interests of the company. As it is *principle-based, Appendix 1* does not keep pointing out that exceptions may be justified in special cases. There can be specific situations, such as when a company is going through a difficult period (e.g. reorganization), when a top manager needs to be recruited from outside. In such a case the Compensation Committee should give succinct reasons for its decision to make an exception (see also para. 6 section 2).

Section 3 opposes the issuing of option rights at prices below the current market value. The decisive factor is not the price at the time the options are later exercised, but that which applies on the day that the Committee or the Board of Directors resolves to make the allocation. As a principle it is recommended that the issue price should be *higher than* the average price on the day that the allocation was decided on (this price can also be determined by taking the average over a relatively short period leading up to that date). This is however still a *recommendation* only; each company should decide for itself whether it wishes to set the exercise price at the same level as the share price for specific reasons, or by how much (e.g. 2%, 5%, 10%) the share price has to rise before the managers' options are in-the-money.

Bounties that are not objectively justifiable could arise, for example, from *windfall profits* which are not linked to the performance achieved by top managers. Share-based incentive schemes should be set up in such a way that, when benefits are assessed, top managers do not derive any substantial advantage from movements in the company share price that do not exceed the mean share price performance of the relevant sector or of the company's main competitors. This applies only to the *assessment* criteria at the moment the decision was taken regarding the compensation, and not any later price movement. *Furthermore, the compensation system should never use a temporary rise in the share price as a basis for assessing an incentive*.

At this point we should expressly draw attention to two other undesirable formulations which do not, however, need to be dealt with in the context of *Appendix 1*:
— the *repricing* of out-of-the-money options (this is in any case already proscribed under para. 26 of the *Swiss Code*);
— the *backdating* of options (this is clearly in contravention of Swiss law, at least in the typical cases).

Re para. 6 (no golden parachutes and no severance packages)
The text of *Appendix 1* makes two things clear under this principal rule:
1 there may be rare exceptions when *golden parachutes* (in the case of a change of control) or *severance packages* (in cases other than a change of control) may to some extent be justified to compensate for the termination of a top management position in the company. The Appendix does not therefore rule out such agreements totally, but only "*in principle*". It does, however, set out the criteria for admitting an exception. These criteria are strict;
2 on the other hand there is no doubt that *golden parachutes* (and also *severance packages* in cases other than a change of control) should be *avoided* in principle. These, more than any other compensation decision, tend to undermine the credibility of a system that grants autonomy of action to major companies.

Cases in which a severance package (this refers exclusively to an undertaking by the company to pay *special benefits* extending beyond those usually payable on termination of the existing contractual relationship) could *exceptionally* be justified are: avoiding costly lawsuits with an uncertain outcome; and ensuring the fulfilment of ongoing liabilities. If a company going through a process of *reorganization* needs to attract an outstanding senior executive, an undertaking to make a severance package could also be justified. However, the Compensation Committee has a duty to ensure that the undertaking to make such a special payment agreement is restored when the company has been successfully restructured.

The distinction is somewhat blurred between justifiable special payments for *exceptional* performance (in the interests of the company) that has not been otherwise compensated, and a "golden handshake" which is in reality being offered in the interests of the outgoing employee rather than those of the employer. *Appendix 1* seeks to make this quite clear: the interests of the company are paramount.

Appendix 1 covers *both kinds* of special payment, golden parachutes (change of control) and severance packages in cases other than a change of control ("*bye-bye money*").

Section 1 clause 2 (a) excludes from the recommendations on "golden parachutes" the various *acceleration clauses* that may apply when a change of control has taken place. Admittedly, arrangements of this nature may amount to wrongful incentives: certain people who stand to gain from *acceleration clauses* may work with the sole aim of achieving this change of control, even though a stand-alone approach might appear to be a better solution for the company. *In the first place,* however, such cases are relatively rare, and it is the Compensation Committee's job to intervene if they should arise. *Secondly,* there is no convincing justification for avoiding *acceleration clauses* per se, since if a change of control takes place it may be appropriate to do away with the old incentive scheme originally set up by the outgoing regime. It is always up to the Board of Directors to seek an appropriate solution in the particular circumstances, with due regard to the recommendations in this Appendix.

Section 1 clause 2 point (b) makes clear that *paragraph 6* as a whole is not contrary to the employer fulfilling its contractual obligations in cases where an employee leaves the company and where each party honours the expected rights and duties in a regular process of terminating the employment relationship. The *payment of bonuses* that are not in the strictest sense contractually binding may count as part of the normal termination of employment if the employee is granted (on a pro rata basis) not more than the equivalent of the amount which he would have received if the employment relationship had continued. If the bonus would have been reduced if the employment had continued, it should also be proportionally reduced when the employee leaves. However, in *para. 6*, *Appendix 1* recommends that the Board of Directors should not include golden parachutes and severance packages in the employment contract from the outset; and if this should nevertheless happen in *exceptional* cases, they should be paid only for *exceptional contributions* that have *not already been compensated* by some other means. A distinction must therefore be made: *in principle, Appendix 1* recommends that the Board of Directors should refrain from particular courses of action; this, however, is only a recommendation. Once a *legally binding* undertaking to provide compensation is included in an employment contract, this necessarily imposes a duty to fulfil this commitment. The same may apply to bonus payments provided for in the compensation system.

Where, *exceptionally*, severance agreements are made under the terms of *paragraph 6* (in advance, or only after actual severance), then the *disclosure* of the conditions of each separate agreement of this nature is decisive (*section 3*). It might appear more appropriate to include this topic (transparency) in *paragraph 10*, which deals with that subject. To do so, however, would create the false impression that commitments of this kind are to some extent a normal feature of a compensation system. Transparency therefore comes under *section 3* at the end of *paragraph 6*, which addresses these matters.

Any *disclosure by the Board of Directors* under *section 3* regarding the exceptional payment of a golden parachute, or a severance package in a situation other than that of a change of control, relates to the individual case. Since it is dealing with an exception – *Appendix 1* making it quite clear that golden parachutes and severance packages are in principle undesirable – the Board of Directors will not, in practice, be able to avoid describing all the particularities of the individual case; it will need to demonstrate that the criteria provided for in *Appendix 1* are met . A duty to provide detailed justification would, on the other hand, be excessive.

Re para. 7 (external yardsticks and consultants)
This paragraph puts forward recommendations that have meanwhile become established as good practice. If a company brings in external consultants, the latter should *not* be selected, appointed or have their level of remuneration decided on by the management, but by the Compensation Committee, in order to avoid obvious interdependencies. Transparency is dealt with in *paragraph 10*.

c Role of the General Meeting

Re para. 8 (compensation report)
In many public companies the compensation report, which first appeared in the United Kingdom, has proved itself as a tool that enables the Board of Directors to present the shareholders with information in an easily readable format showing how the compensation system has been applied over the past financial year. *Paragraph 8* on the compensation report should not be read in isolation, but in connection with the preceding paragraphs relevant to this subject. The recommendations in *paragraph 8* do not go as far as the new requirements laid down by the *SEC*, for example, but they do target the main issues and mention the importance of setting material out in tabular form. Communicating in an open and easily comprehensible manner is ultimately a key factor if a compensation system is to be accepted.

Section 1 clause 2 makes clear that the *tables* relate to many matters arising from the duty of disclosure set out in the legislation (art. 663b^{bis} and art. 663c section 3 OR). The Appendix makes no recommendation regarding the layout and degree of detail of these tables – that is a matter for individual companies, which are free to base their presentation on standard models or implement their own ideas. The individual compensation received by the members of the Executive Board does not have to appear in the tables, but a company which considers this information appropriate is free to provide it. The principle is that the value flows are depicted – also in tabular form – particularly to the extent it is necessary to draw comparisons with the previous year and make the various movements readily apparent.

Section 2 makes it clear that the content of the compensation report is necessarily correlated with the figures in the *Annual Financial Statement* (staff costs) and the *Notes* (art. 663b^{bis} OR), so the declaration of value must be stated in compliance with the *financial reporting standards applicable* thereto (usually IAS/IFRS). If a company also wishes to provide *fiscal* tax value in respect of particular cantons, it is at liberty to do so.

The compensation report by no means has to be produced as a separate *booklet* in addition to the annual report; it can – and often does – take the form of a *section of the annual report*.

One inevitable difficulty arises from the change in the law of 7 October 2005: disclosure of compensation and loans to directors and senior managers is a compulsory component (subject to the scrutiny of the *company auditors*) of the *annual financial statements*, i.e. the *Notes* thereto. In any event, the key figures on compensation paid to the members of the Board of Directors and the Executive Board which show how the compensation system has been applied must appear in the *compensation report*, even if this leads to partial repetition of the legally stipulated content of the *Notes to the annual financial statements*.

Re para. 9 (involvement of the General Meeting)
The compensation report should be debated at the General Meeting in an appropriate form. Each company may *choose freely* between several *options*.

It should first be pointed out that the Working Group discussed, but *rejected*, *two other options that were initially considered* regarding the involvement of the General Meeting in matters to do with compensation.

1 An option of requiring the General Meeting to determine the amount of compensation paid to the *members of the Executive Board* was *ruled out*. From a purely legal point of view there appears to be general agreement that the General Meeting is not empowered to take such personnel decisions in respect of the members of the senior management team who report directly to the Board of Directors. Furthermore, it is clear that the shareholders are not in a position to obtain all the indispensable information that would be required for them to undertake the often sensitive task of determining the individual salaries of senior managers.
2 Another possible solution was also discussed but *not taken any further*: requiring the General Meeting to vote – as a *binding general resolution* – on the compensation to be paid to *each individual member of the Board of Directors*. Companies should decide on this matter at their own discretion; recommending an option in this respect is not appropriate. From a strictly legal point of view, the current Code of Obligations does not make clear whether such a decision would fall under the *tantième* provisions. If so, the compensation so resolved would be subject to additional requirements and would moreover count as an act of *profit distribution* (which would exclude the opportunity to make it tax deductible). This would also present practical problems, in that the level of compensation payable to members of the Board of Directors who also perform executive functions would be decided on by the shareholders directly. This is not compatible with the concept set out in *Appendix 1* whereby responsibility for determining the individual compensation packages of all executive members of the Board of Directors and Executive Board should lie with the Board of Directors.

Two options are put forward here, without taking a view as to which is preferable:

Option 1 brings the compensation report into the discussion at the General Meeting under the heading of a compulsory agenda item, i.e. in connection with the resolution on the *Approval of the Annual Financial Statements* (art. 698 section 2 para. 4 OR) or the *Discharge to the Board of Directors* (para. 5). The first of these suggestions is based on the principle that, on account of its subject matter, the compensation report falls naturally under the item *Staff Costs* (in respect of the top level of management and the Board of Directors). In the second case, the Board of Directors also explicitly seeks to obtain, by means of the *Discharge*, a positive vote approving its compensation policy for the past financial year; it makes clear that the discharge resolution, which in legal terms represents an agreement not to bring liability actions against the Board of Directors, is also to specifically include approval of the *discretionary judgements* disclosed by the Board in relation to the compensation system. In both cases it is recommended that the Chairman of the Board of Directors – or, in matters to do with his compensation or the compensation to be awarded to other executive members of the Board of Directors, the Chairman of the Compensation Committee – should give the shareholders additional information about the compensation system and the most important decisions that have been made based on it, and should take questions on this topic. The Board of Directors should establish whether the commentary on the compensation report should be given by the Chairman of the Board of Directors or the Chairman of the Compensation Committee; the guidelines on this are to be found in the *Swiss Code* itself, while further recommendations appear in *Appendix* 1.

Option 2 largely corresponds to the *principles enshrined in the British model*. The shareholders express their personal opinions consultatively, and not in the form of a *resolution* which would be binding upon the company (as a legal entity) in accordance with art. 703 OR. Responsibility remains with the Board of Directors, although the latter should certainly take the opinion expressed by the majority of shareholders into account as an important, although not in itself the decisive, factor in its deliberations. In essence, the British model consists in taking a vote on the *written reports and accounts* for the past financial year. The shareholders thus implicitly also pronounce on the compensation system underlying the reports and accounts as well as on the actual compensation decisions made on this basis and described in the report.

It is up to the individual companies to give thought to the *legal aspects* of the option they prefer. In this respect it should be borne in mind in particular that current Swiss company law contains no explicit provisions concerning consultative votes (*option 2*) and that the company cannot pay a dividend (*option 1*) if the annual financial statements are not approved.

Each individual public company is called upon to develop its own policy on these options and to present these to the shareholders – or to work out a *different, third option* for itself.

d Transparency

Re para. 10 (transparency)
According to the "division of tasks" agreed in the spring of 2002 regarding *transparency* (Guideline of the SWX Swiss Exchange) and *content* (recommendations of economiesuisse), the subject of paragraph 10 would come under the Stock Exchange Guideline. As long as it is not yet addressed by the Guideline, the present recommendation is valid and there is *no* duty to *comply or explain*.

The recommendation on *transparency* follows a *middle way* which prevails throughout the entire appendix. Both the recommended level of detail and the depth of the analysis are a far cry from those required, since 2006, of public companies registered in the USA under *SEC* rules.

The *content* of the compensation report is primarily regulated in *paragraph 8*, and not in this provision on transparency. A number of other recommendations in the *context of Appendix 1* have a bearing on the disclosure of the compensation report and are not repeated here. This refers to the following paragraphs in particular: *para. 3 section 3* and *section 4; para. 5 section 3 and para. 6 sections 2 and 3.*

Section 2 is of practical significance for the *credibility* of the manner in which the matter of compensation paid to the members of the Board of Directors and the Executive Board is handled. In respect of the Executive Board, the explanations provided in the compensation report need only show the total amount paid to the Executive Board overall, apart from always stating the amount of compensation received by its highest-paid member. The sums paid to the latter must be shown *separately* in compliance with art. 663b^{bis} OR. In nearly all cases – with well-known exceptions – the *President* is the highest-paid member of the Executive Board. The law does not require the compensation payments awarded to the other members of the Executive Board to be disclosed on an individual basis, and according to *Appendix 1* these do not need to be given individually. However, each company is free to go into this point in more detail if it so wishes.

In *section 2 clause 2*, the Board of Directors is called on to state why the compensation payments disclosed have changed in relation to the previous financial year. However obvious the reasons may be internally, the shareholders need these explanations in order to understand the bigger picture.

The *values stated* in accordance with *para. 10* refer to the figures compiled in compliance with the relevant *accounting standards* (especially IFRS/IAS) in respect of the shares or share options already allocated as well as the value of rights of this kind held by the members of the Board of Directors and Executive Board on the reporting date.

Section 3 is – perhaps contrary to first impressions – not redundant, since otherwise some might worry that the production of a *separate* document in addition to the annual report is required. This is not the case; as mentioned above, the Board of Directors can publish the compensation report as a *section of the annual report*.

Section 4 refers to the ultimately insoluble problem already referred to above: how to avoid repetition of the information contained in the new, legally required section of the *Notes to the Annual Financial Statements* (in accordance with art. 663b^{bis} and art. 663c section 3 OR)? Paragraph 10 sets out some possibilities, and each Board of Directors has to make its own decision regarding presentation.

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