# ISS FAQ: Ordinance Against Excessive Remuneration Switzerland 2014

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## Introduction

The purpose of this publication is to provide ISS clients with information on the new voting items introduced by the Ordinance Against Excessive Remuneration at Listed Companies, as well as to provide insight, context, and analysis of how these items are likely to be proposed by companies in practice. In addition, this publication describes the analytical approach that ISS will take when evaluating these voting items. This publication is not a policy document and does not replace the ISS policy approach to evaluating Swiss companies; rather, it clarifies how ISS will apply its benchmark voting policy in 2014 in light of the aforementioned changes to Swiss law.

In March 2013, voters in Switzerland approved a national referendum known as the Popular Initiative "Against Rip-Off Salaries" by a 68-percent majority, with the referendum receiving majority-support in all Swiss cantons. The referendum, also colloquially known as the Minder Initiative after its main proponent, businessman-turned-MP Thomas Minder, took aim at executive and director pay practices at public companies by seeking to transfer certain decision making powers from the board of directors to shareholders. The referendum also called for bans on certain forms of compensation (such as severance and remuneration in advance), a voting requirement for Swiss pension funds, and criminal sanctions for failure to comply with any of the various stipulations contained the initiative.

The Swiss parliament is responsible for transposing the Minder Initiative into law, and this is expected to take several years. However, the terms of the Minder Initiative required the executive branch of the Swiss federal government, the Federal Council, to enact an ordinance within one year of the referendum's passage for the purpose of transposing the referendum into law on a provisional basis. The final version of the Federal Council's ordinance (known as the Ordinance Against Excessive Remuneration at Listed Companies, hereafter "the Ordinance") was published on Nov. 20, 2013, and the new requirements of the ordinance took effect Jan. 1, 2014.

The Ordinance contains numerous new requirements and regulations that apply to all

listed Swiss companies and Swiss pension funds, including a series of voting items that will need to be included on the agendas of Swiss company AGMs in 2014 and beyond. This document focuses exclusively on these new voting items.

Other stipulations of the Minder Initiative – including new disclosure requirements, banned forms of compensation, the requirement for companies to provide shareholders with electronic voting facilities, the voting and disclosure requirements for Swiss pension funds, and criminal sanctions for non-compliance with the law – are not covered in this document.

## What Are the New Voting Items Shareholders Will See?

The Ordinance creates a series of new voting items that shareholders must resolve on at each ordinary annual shareholders meeting as routine business. All of these voting items have binding effect. They are:

Mandatory from 2014:

- Election of each member of the board of directors on an individual basis.*
- Direct election of the chairman of the board of directors.
- Direct election of the members of the compensation committee of the board of directors on an individual basis.
- Election of the independent proxy.

Mandatory from 2015:

- Approval of the aggregate compensation of the board of directors.
- Approval of the aggregate compensation of executive management.
- Approval of the aggregate compensation of the advisory board.**

*Three-year board terms were the legal standard in Switzerland prior to Jan. 1, 2014. Some Swiss companies already provide for annual director elections on an individual basis.

**The advisory board has no legal competencies. Most Swiss public companies do not have advisory boards, and disclosure on advisory boards tends to be minimal.

In addition, aspects of compensation policy and other items directly or indirectly related to the compensation of members of the company's governing bodies, including measures intended to prevent circumventing the rules of the Ordinance, must be established in each company's articles of association. This will require shareholders to approve various article amendments, which will also therefore appear as voting items in 2014 and 2015. In particular, shareholders will be required to pass article amendments on:

- The number of allowable external mandates that members of the board of directors, executive management, and advisory board may hold in Swiss companies outside of the group and in foreign companies.
- The maximum length of contracts for members of the board of directors, executive management, and the advisory board.
- Principles concerning the tasks and responsibilities of the compensation committee.
- Details concerning the procedure for voting on the aggregate compensation of the board of directors, executive management, and advisory board.
- The amount of any loans, credits, or pension payments outside of the workplace pension plan allocated to members of the board of directors, executive management, and advisory board.
- The principles of any performance-related remuneration to members of the board of directors, executive management, and advisory board.
- Principles concerning the awarding of any equity-linked remuneration to members of the board of directors, executive management, and advisory board.
- The transfer of business leadership to any person(s) outside of the board of directors.
- The additional remuneration that may be paid to any members of executive management who join after the shareholder resolution on compensation.

- Details concerning the procedure that would take place if a shareholder resolution on compensation is rejected.
- Any deviation from the legal standard concerning the procedure for electing the board chairman, members of the compensation committee, and the independent proxy.
- Any compensation paid to members of the board of directors, executive management, or advisory board by direct or indirect subsidiaries.

Furthermore, companies will need to propose various amendments of a housekeeping nature in order to bring their articles into line with new requirements of the Ordinance where companies are not given a choice on implementation (e.g. annual election of directors).

## What Companies Are Impacted, and From When?

The Ordinance affects Swiss law and applies to all listed companies incorporated in Switzerland (including those that may be listed on foreign stock exchanges such as the NYSE or NASDAQ). It does not apply to companies incorporated outside of Switzerland with a listing on a Swiss exchange.

Companies impacted by the law are required to implement most of the new voting items at their first ordinary shareholders meeting following implementation of the Ordinance (i.e. 2014). The first major new voting resolutions that will come into effect for 2014 are the annual individual board elections, direct election of the board chairman, and direct election of the compensation committee members.

Companies will not be required to submit binding votes on compensation and amendments to the articles of association until the second AGM following implementation of the Ordinance, i.e. 2015.

## What Will Be the Impact on Shareholders' Voting Workload in 2014?

As noted above, Swiss companies will not be required to submit resolutions on director or executive compensation or article amendments until 2015. However, in 2014, the number of voting items for Swiss AGMs will increase due to the requirements for annual board elections, direct election of the board chairman and compensation committee members, and election of the independent proxy. In 2013, there wasan average of 12 voting items at the ordinary general meetings of companies in the blue chip SMI index. In 2014, this average is expected to increase to somewhere in the neighborhood of 25 voting items.

Many companies are expected to include resolutions on article amendments in 2014, even though this is not mandatory until 2015. A few companies can also be expected to voluntarily give shareholders binding votes on compensation in 2014, while others are expected to give a non-binding vote on the compensation report as recommended by the Swiss Code of Best Practice. Some companies are also expected to run a "dress rehearsal" for 2015 by submitting non-binding versions of the resolutions on compensation required by the Ordinance.

## Information on New Voting Items

### Direct election of board chairman and Remuneration Committee members

The Ordinance stipulates that the chairman of the board of directors and members of the Remuneration Committee are elected directly by shareholders.

#### *What is the voting requirement?*

The resolutions require the approval of a simple majority of represented voting rights (i.e., 50 percent plus one vote), unless the company has

set a different voting standard in its articles of association, such as majority of votes cast. If the company defaults to the legal standard of majority of represented voting rights, abstentions effectively count as votes against the resolution.

***Will elections to the board chairmanship and to the remuneration committee be separate from the individuals' elections to the board, or could a nominee's election to the board be bundled with his/her election as board chairman or member of the remuneration committee?***

Companies may take either approach. For example, a candidate could be nominated to the board and also to the remuneration committee in two separate voting items, or the candidate could be nominated as board member and remuneration committee member in the same voting item.

Note that the board chairman and the remuneration committee members must be members of the board of directors.

***What happens if shareholders reject the resolution to elect the board chairman or members of the remuneration committee?***

If the board's nominee for chairman is rejected by shareholders, the board may name an interim chairman for the remaining term until the next ordinary shareholders' meeting. Likewise, if the remuneration committee is not fully staffed, the board may name replacement members for the remaining term until the next ordinary shareholders' meeting. The company's articles could also provide alternative ways for naming a replacement chairman or remuneration committee members.

## Election of an independent proxy

The Ordinance also requires that shareholders elect an independent proxy. The term of the independent proxy lasts until the next ordinary shareholders' meeting.

The independent proxy is an administrative function in the voting chain for shareholders voting by proxy in Switzerland. Under the previous Swiss legal framework, shareholders that did not attend the AGM in person could have proxy representation at the meeting provided by another shareholder with voting eligibility (or a third party which need not be a shareholder, depending on the company's articles), the company proxy, the independent proxy, or the shareholder's custodian. The Ordinance abolishes proxy representation by the company proxy and by custodians.

The independent proxy can be either a natural or legal person, and must be independent as defined by Art. 728 of the Swiss Code of Obligations, which is the same definition of independence applied to external auditors.

Under the new legal framework, the independent proxy is required to exercise the voting rights it represents according to the shareholder's instructions and if no instructions are received the independent proxy is required to abstain. The board is required to make sure that shareholders are provided with the opportunity to submit specific voting instructions to the independent proxy for all announced proposals for voting items on the agenda, as well as general instructions for any unannounced proposals for voting items on the agenda. The board is also required to make sure that shareholders are able to submit powers of attorney and voting instructions to the independent proxy via electronic means.

***What is the voting requirement?***

The resolution to elect the independent proxy requires the approval of a simple majority of represented voting rights (i.e., 50 percent plus one vote), unless the company has set a different voting standard in its articles of association, such as majority of votes cast. If the company defaults to the legal standard of majority of represented voting rights, abstentions effectively count as votes against the resolution.

***What happens if shareholders reject the independent proxy?***

If the company does not have an independent proxy approved by shareholders, the board may name an independent proxy for the next shareholders meeting.

Shareholders are also allowed to vote out the independent proxy at the end of the shareholders' meeting.

## Binding resolutions on the remuneration paid to the board of directors, executive management, and advisory board

Starting from 2015, the Ordinance gives shareholders the final authority for approving the aggregate remuneration paid to members of the board of directors, executive management, and advisory board (if the company has one).

It should be noted that, unlike in many other say-on-pay markets, the shareholder vote on board and executive management remuneration foreseen by the Ordinance does not concern the remuneration system or structure as such, but rather the total quantum of remuneration that can be paid to members of executive management, expressed in Swiss francs.

Each company is free to determine the template for the vote on remuneration as long as (a) shareholders are given a vote on remuneration each year, (b) shareholders can vote separately on the remuneration of the board, executive management, and advisory board (if applicable), and (c) the shareholder voting result has binding effect. As a result, shareholders are likely to see various different types of voting resolutions, particularly with regard to the remuneration paid to executive management.

The following are some of the voting options that Swiss issuers are currently considering for the resolutions on the remuneration of executive management:

- Two separate binding resolutions on the aggregate compensation for executive management: a forward-looking vote on fixed pay for the upcoming financial year, and a retrospective vote on the variable remuneration paid for the past financial year ("split vote").
- A single, forward-looking binding resolution on the aggregate compensation of executive management for the upcoming financial year ("budget vote").
- A split vote for a one-year period beginning several months after the AGM, e.g. from July 1 to June 30 of the following year.
- A budget vote for the period beginning several months after the AGM, e.g. from July 1 to June 30 of the following year.
- A split vote as well as a separate, non-binding vote on the compensation report or system.
- A budget vote as well as a separate, non-binding vote on the compensation report or system.

*(Note: the non-binding vote on the compensation report is not a requirement of the Ordinance, but is recommended by the Swiss Code of Best Practice and has been adopted by a majority of mid- to large-cap Swiss companies over the past five years).*

Because Swiss companies rarely award variable compensation to non-executive directors, it is generally understood that most companies will structure the shareholder resolution on non-executive director compensation as a single, forward-looking vote from AGM to AGM. However, companies that award variable compensation to their non-executive directors, as well as companies with executive directors serving on the board, may propose spit votes for the board of directors.

### *What is the voting requirement?*

The resolutions require the approval of a simple majority of represented voting rights (i.e., 50 percent plus one vote), unless the company has set a different voting standard in its articles of association, such as majority of votes cast. If the company defaults to the legal standard of majority of represented voting rights, abstentions effectively count as votes against the resolution.

### *What happens if a binding vote on remuneration is rejected?*

According to the Ordinance, any remuneration paid to members of the board of directors, executive management, or advisory board must be approved by shareholders.

Companies are required to amend their articles in order to stipulate the procedure that would take place if shareholders reject a binding pay resolution. The following are options that would be open for the board to take if shareholders

reject a binding pay resolution, as long as these options are provided for in the company's articles:

- The board could make a second binding proposal at the AGM.
- The board could call an EGM at a later date in order for shareholders to approve a new binding proposal.
- The board could submit a new binding proposal to shareholders at the next ordinary shareholders' meeting (e.g. for approval on a retrospective basis).

The overarching principle is that any remuneration that is paid to the board of directors, executive management, or advisory board must be approved by shareholders at some point. Therefore, a company's articles could not stipulate that, in the event of a rejection by shareholders, remuneration would be set by the board of directors or compensation committee, or that remuneration would default to the previous year's level.

The impact of a shareholder rejection would depend partly on the voting template chosen by the company. In the case of a prospective vote, remuneration could still be allocated if shareholders reject the board's resolution, though any remuneration paid out under these circumstances would be subject to potential claw back, e.g. if shareholders subsequently approve a lower level of remuneration. In the case of a retrospective vote (e.g. on variable remuneration), a rejection would mean that the remuneration proposed by the board could not be allocated. If remuneration had already been allocated, it would be subject to claw back. In this situation, the board could decide to propose a new level of remuneration, e.g. either at the meeting itself, or at a later shareholders' meeting, depending on the terms set in the company's articles.

It should be emphasized that the focus of binding pay resolutions foreseen by the Ordinance is on aggregate pay quantum. If shareholders reject a binding pay resolution, the board and, in some cases, shareholders may propose a different amount of money/payment in kind that could be allocated to the respective governing body.

### *What disclosures are companies required to provide?*

The Ordinance requires boards of directors of listed companies to produce a remuneration report annually. The report must disclose all remuneration that the company has directly or indirectly paid to current members of the board of directors, executive management, and advisory board (if applicable), as well as any direct or indirect remuneration to former members of the board, executive management, or advisory board in connection with their prior activities as members of the company's governing bodies during the financial year in question. The company's external auditing firm must audit the remuneration report to confirm whether it complies with Swiss law and the Ordinance.

The following qualify as remuneration:

- Honoraria, salaries, bonuses, and credit notes;
- Profit sharing, participation in revenues, or other participations on the company result;
- Services and non-cash benefits;
- Allocation of equity participations, conversion rights, and option rights;
- Sign-on bonuses;
- Guarantees, indemnity bonds, pledging on behalf of third parties, and other securities;
- Relinquishment of debt demands;
- Expenditures that justify or raise benefits claims;
- All benefits for additional work;
- Loans and credits.

The remuneration disclosures comprise:

- The total remuneration of the board of directors as well as the individual remuneration paid to each board member;
- The total remuneration of executive management as well as the remuneration of the highest paid individual member of executive management;
- The total remuneration of the advisory board as well as the individual remuneration paid to each member of the advisory board (if the company has an advisory board);

- If applicable, the additional amount of remuneration paid to members of executive management who joined after the shareholder resolution approving the total remuneration of executive management, as well as the remuneration paid to each individual new joiner.

The remuneration report must also include disclosure of any loans, credits, or other forms of remuneration to closely related parties of members of the company's governing bodies which are not made at market conditions.

It should be emphasized that the remuneration report concerns remuneration allocated in the last financial year. The Ordinance and Swiss corporate law do not make any particular requirements as to how the company describes its remuneration philosophy or remuneration system in its disclosures, or how it plans to allocate remuneration in the coming year.

## Article Amendments

The Ordinance stipulates that certain aspects of compensation policy for members of the company's governing bodies must be established in the articles of association (e.g. principles of variable and equity-linked pay, contract lengths, tasks and responsibilities of the compensation committee). Additionally, because the Ordinance grants companies a degree of flexibility in how they structure the binding resolutions on compensation, the structure of the say-on pay-resolution(s) needs to be set in the company's articles. Also, shareholders need to approve an article amendment on the procedure that would take place if a vote on compensation is rejected.

There are also a number of other required article amendments that do not directly relate to compensation matters; many of these amendments are intended to close potential loopholes or provide shareholders with control over additional compensation for executives or directors (e.g. compensation from group companies, limit on the number of outside board mandates, and the amount of loans, credits, and pension payments to members of governing bodies).

In addition, there are a number of article amendments that are required purely for compliance with new mandatory legal requirements.

Many of the required article amendments have no real equivalent in other jurisdictions because they concern aspects of compensation policy or other governance matters that are generally left to the board of directors or management to decide, or which shareholders vote on in a separate resolution.

### *Will the article amendments be voted on separately, or will companies propose a bundled resolution on all amendments?*

ISS is aware that a number of Swiss companies plan to submit the new article amendments as single, bundled resolution, rather than allowing shareholders to vote on the amendments individually. Companies have noted that, when taking the sum total of required amendments into account (including amendments that simply reflect new legal requirements, e.g. reducing board term lengths to one year, stipulating that shareholders directly elect the board chairman, and so forth), they may end up needing to make 40-50 separate article amendments. This, companies argue, would make separate resolutions an unwieldy prospect.

On the other hand, some of the companies that held early shareholder meetings this year have separated out article amendments by type (e.g. mandatory transcription of legal requirements, principles of compensation, contractual terms, etc.).

### *What is the voting requirement?*

According to the Swiss Code of Obligations, amendments to the articles of association such as those required by the Ordinance generally require the approval of a simple majority of represented voting rights (i.e., 50 percent plus one vote), unless the company has set a different voting standard in its articles of association, such as majority of votes cast. Companies may set higher majority requirements in their articles.

***What are the key article amendments?***

1. Structure of binding pay resolutions/procedure in case of shareholder rejection of a binding pay resolution

Please refer to "Binding Resolutions on the Remuneration Paid to the Board of Directors, Executive Management, and Advisory Board."

2. Additional amount for new joiners

The Ordinance allows companies to specify the amount of additional remuneration that could be paid to any member of executive management who joins after the shareholder resolution on aggregate remuneration. This would prevent the need for the company to call an EGM in order to obtain shareholder approval to pay new joiners.

Most companies that decide to include this article amendment are expected to propose that any individual that joins the executive management during the year, or all new members who join during the year in aggregate, could be paid up to a certain specified percentage of the remuneration of executive management that was approved by shareholders.

3. Principles of variable and equity-linked remuneration

The Ordinance requires the principles of any performance-related or equity-linked compensation paid to members of the company's governing bodies to be established in the articles of association.

The Ordinance does not prescribe any particular level of granularity with respect to the description of the company's remuneration principles in the articles.

4. Maximum length of executive contracts / notice periods

The Ordinance requires Swiss companies to set the maximum contract length for members of executive management in the Articles of Association.

Currently, most large Swiss companies use rolling contracts, and notice periods are rarely longer than one year, which shareholders typically consider to be a reasonable length of time. Moreover, the Ordinance will introduce a one-year cap for contract lengths and notice periods, and will ban lump sum severance agreements. However, non-compete agreements are still permitted, and contractual obligations may still be paid out during the notice period.

5. Principles concerning the tasks and responsibilities of the Remuneration Committee

The Ordinance requires Swiss companies to specify the tasks and responsibilities of the board of directors' compensation committee in their articles. Previously, the tasks and responsibilities of the compensation committee were generally fixed in the board of directors' regulations, which were not subject to shareholder approval.

Swiss law does not grant the compensation committee any specific duties or powers. According to the Swiss Code of Obligations, the board of directors may transfer responsibility for the preparation and execution of its resolutions or the oversight of businesses to committees or individual board members.

6. Transfer of business leadership to persons outside of the board of directors

The Ordinance requires the articles to be amended if leadership of the business is transferred outside of the board of directors. This requirement is based on a stipulation of the original referendum which was intended to prevent companies from circumventing shareholders' approval of executive compensation by transferring executive management to an outside corporate body. However, an existing legal provision already prevents non-natural persons from being members of corporate governing bodies or being signatories in the trade register.

The Swiss Code of Obligations (Art. 716a) stipulates the non-transferable and indefeasible responsibilities of the board of directors – which include, among other things, the overall leadership of the company; the structuring of bookkeeping, financial controls, and financial planning; hiring and dismissal of executive management; oversight of executive management; and preparation of the annual report and execution of the AGM. Art. 716b – allows the board to transfer executive

management of the company to individual members of the board or third parties.

### 7. Number of outside board mandates

The Ordinance requires Swiss companies to set the maximum number of allowable outside board mandates for members of its governing bodies in the Articles of Association. According to the law, outside mandates refer to board mandates at listed and unlisted domestic and foreign entities outside of the group.

### 8. Loans, credits, and pension payments

The Ordinance requires an article amendment on the amount of any loans, credits, or pension payments outside of the workplace pension plan allocated to members of the board of directors, executive management, and advisory board.

# ISS' Approach

## Binding votes on remuneration

***What is ISS' approach to evaluating proposals on remuneration at Swiss companies and will it change due to the new requirements?***

ISS analyzes companies incorporated in Switzerland under its European benchmark governance policy. This voting policy incorporates relevant market-specific factors based on each market's local practice and corporate governance code, including for Switzerland the Swiss Code of Best Practice. At the same time, the policy retains a baseline that considers general standards of good corporate governance practice internationally.

ISS' European benchmark policy on compensation practices is based on five global principles of compensation. In essence, ISS believes that companies with good compensation practices adhere to the following principles:

1. Provide shareholders with clear; comprehensive compensation disclosures;
2. Maintain appropriate pay-for-performance alignment with emphasis on long-term shareholder value;
3. Avoid the risk of pay for failure;
4. Maintain an independent and effective compensation committee;
5. Avoid inappropriate pay to non-executive directors.

When analyzing compensation proposals, ISS considers the degree to which companies' compensation practices live up to the aforementioned principles, while taking local practices into account. This will not change due to the new requirements.

***Will ISS change its approach to analyzing remuneration at Swiss companies following implementation of the Ordinance?***

No. ISS has made one change to its European benchmark policy on compensation with regard to pay levels, but for the most part ISS policy will remain the same as before for the time being. Depending on how practice in the market evolves, ISS may make further amendments to its voting policy in the future.

However, it is important to make a clear distinction between ISS' European compensation policy and the application of this policy, because application depends on the specific focus of the say-on-pay vote as well as other market-specific factors.

Although many European countries have adopted some form of shareholder say-on-pay, there are still vast differences in terms of what the focus of the say-on-pay vote is in each market (e.g. remuneration policy, compensation report, pay levels), the governing bodies whose compensation is subject to shareholder approval (executive management, board of directors, all employees), vote frequency (annual, periodic, only when there is a material change to compensation policy), impact (binding vs. non-binding), and whether local law or listing rules provide shareholders with the opportunity to vote on specific aspects of compensation practice (e.g. shareholder approval over equity plans, board of directors compensation, severance packages, etc.).

Moreover, actual compensation and disclosure practices still differ significantly from market to market. Because of these differences, ISS takes market-specific factors into account when analyzing compensation practices and applying its benchmark voting policy.

The Ordinance creates a series of new voting resolutions on compensation requiring shareholder approval, and ISS' application of policy will be adapted as a result. Under the previous Swiss regime, shareholder say-on-pay was fully voluntary and non-binding, and essentially consisted of one "all-in-one" vote on the compensation report for those companies that voluntarily put say-on-pay on their annual meeting agenda. Within this structure, if shareholders objected to any aspect of a company's compensation practices, then the advisory vote on the compensation report was the only opportunity to directly express dissent by voting.

After the Ordinance takes effect, shareholders will have the opportunity to vote directly on various aspects of compensation practices and policy, including binding votes on the total pay of the board and executive management and article amendments on the principles of variable and equity-linked remuneration, loans, and contract lengths. This means that, instead of having one "all-in-one" vote, shareholders will have multiple votes on compensation, allowing them to express a direct view on various aspects of compensation.

***Does ISS have a preference for a particular template for the binding votes on remuneration?***

No, ISS has no preference. This is the choice of each company.

Swiss companies are contemplating at least two main possibilities for structuring the shareholder votes on the remuneration of executive management: an "all-in-one" forward-looking vote on total remuneration (the so-called "Budget" approach) or a forward-looking vote on fixed remuneration together with a retrospective vote on variable remuneration (the "split" approach).

We think that both the budget and split voting approaches could potentially work, but regardless of which basic approach a company takes, it's important that the structure of the resolutions and the level of disclosure provided by the company allow shareholders' votes to be relevant and meaningful.

With the budget approach, shareholders would effectively be asked to approve the maximum possible level of remuneration that could be allocated to executive management during the year, which is likely to be well above the amount that will actually be paid out. If a company chooses this approach, it's important that it inform shareholders how the budget would be actually utilized (for example, what portion of the budget would be used for fixed remuneration vs. variable remuneration? What level of variable remuneration would be paid out for average (i.e. expected) performance during the upcoming year? What level of performance is required for the maximum possible remuneration to be paid out?). If the company simply proposes a number without any further clarification, the vote will lose much of its relevance for shareholders. Without good information and explanations, ISS may choose to oppose rather than support vague or overly generic proposals.

If a company chooses a split approach, there may be greater transparency on the link between variable pay and actual performance which could help the company in being able to better explain its pay practices to its shareholders. However, the implications of a retrospective "No" vote in this situation could potentially be more serious. In all likelihood, the variable remuneration could not be allocated in such a situation, and the company might need to call an EGM to seek further shareholder approval.

Some companies are also considering whether to continue offering shareholders a non-binding vote on the remuneration report alongside the binding votes required by the Ordinance. We think this could be a sensible option, as it could mitigate some of the concerns about the budget and split voting approaches by providing shareholders with a forum for expressing views on more structural matters regarding the compensation system, whilst still providing a binding resolution which would focus more on the overall pay level and the pay-for-performance link, which is how we understand the intention of the law.

However, ISS does not have a strict preference for how companies should organize their pay votes. We believe that companies should select the option that best suits the company and its shareholders, fulfills all legal requirements, and provides good information on the approach and pay practices they have chosen so that shareholders are able to make informed

decisions on pay and fulfill their obligations as owners.

***If an issue with remuneration is identified, which vote would ISS target in its recommendations?***

In light of the variety of potential types of resolutions on remuneration, ISS will adopt the following analytical approach when evaluating Swiss companies' remuneration practices:

- ISS will apply its voting policy (and any potential voting sanction) to the most appropriate voting item(s) on the meeting agenda. For example, any concerns or potential voting sanctions regarding variable compensation of executive management could be applied to a stand-alone resolution on variable compensation or a budget vote, but not to a stand-alone resolution on fixed compensation.
- If the company provides shareholders with a non-binding resolution on the compensation report or compensation system, ISS will generally apply its compensation policy (and any potential voting sanctions) to the non-binding resolution if there are concerns regarding remuneration structure, as well for more minor concerns in general. At the same time, ISS would reserve the right to apply voting sanctions to the binding resolution(s) for serious concerns, such as fundamental pay-for-performance failure. We believe this is a sensible approach which is in shareholders' interests and consistent with the intention of the law because:

  (a) As noted above, the binding say-on-pay resolution foreseen by the Ordinance focuses on absolute remuneration paid to executive management. If shareholders reject a binding say-on-pay resolution, the expectation under the law is that either the board or shareholders will make an alternative proposal to pay executive management a different amount of payment than that which was originally proposed by management. Alternatively, the non-binding vote on the compensation report is generally understood to encompass the company's remuneration practices more generally, and is comparable to the type of management say-on-pay seen internationally. It therefore makes sense for shareholders to utilize the vote on the compensation report to express views on structural concerns, disclosure concerns, and the like.

  (b) The impact for the company if shareholders were to reject a binding vote on compensation is potentially more serious than is the case for a rejected vote on the compensation report. If a company chooses the split voting model, a rejection of the retrospective vote on variable pay would mean that executive management could not be paid performance-based compensation until shareholders approve a new amount. Any remuneration paid to executive management after shareholders have rejected a prospective vote is at risk of claw back.

- ISS will take disclosure into account when analyzing the binding vote on executive compensation. If a company proposes a budget vote, it should provide shareholders with detailed, meaningful disclosure on how the budget would be utilized. The proposal should specify how much of the budget could be utilized for fixed remuneration and how much could be used for variable remuneration. Also, since shareholders will effectively be approving the maximum amount of remuneration that could be paid to executive management, the proposal should provide insight into how the allocation of variable remuneration will be linked with company performance.

The above notwithstanding, we emphasize that ISS would retain the right to recommend against the binding resolutions on compensation for serious concerns.

## Article amendments

***How will ISS analyze article changes relating to the Ordinance and apply policy?***

As noted above, it is expected that many companies will provide at least some level of bundled resolutions for amendments to their articles of association.

ISS' analytical approach is to assess article amendments on a case-by-case basis, taking into consideration the effect of the amendment on shareholder rights and whether the proposed change represents an improvement or worsening of the existing article provision. In cases where a series of article amendments are bundled into one resolution, the entire set of amendments is considered together as a whole, taking into account changes which may be positive and negative from shareholders' perspective. In some cases, the presence of one strongly negative change may warrant a recommendation against the entire proposal.

***Are there any particular article amendments that shareholders should pay attention to?***

The Ordinance requires companies to enact article amendments on a wide range of governance issues. Typically, when companies enact article amendments to comply with a change to local law, this entails more or less a straight transposition of the new legal requirements into the articles, and is therefore a fairly non-contentious matter. In this case however, many of the requirements are open-ended, i.e. the company may be required to take a firm position on a certain governance issue, set limits, or establish principles in their articles. As a result, there are potentially several areas where companies potentially could propose amendments that are not in line with shareholders' interests. This may include article amendments that are not required by the Ordinance which companies may decide to bundle. Therefore, ISS will closely scrutinize all article amendments that shareholders vote on.

This notwithstanding, there are a number of article amendments that are expected to be non-contentious in most cases, for instance those that entail a strict transposition of a new legal requirement (e.g. the requirement to hold annual board elections) or amendments where the law restricts companies' ability to enact article provisions that could be harmful to shareholders' interests. A good example of this is the requirement concerning maximum contract lengths for members of executive management. The Ordinance restricts contract lengths and notice periods to a maximum of one year, and furthermore bans lump sum severance agreements. Therefore, the potential impact of lengthy notice periods or long contracts is reduced.

Based on the requirements of the Ordinance, and in light of ongoing discussions with Swiss issuers, ISS has identified a number of article amendments that are likely to warrant shareholder attention.

### 1. Principles of performance-oriented and equity-linked remuneration

The Ordinance requires the principles of any performance-related or equity-linked compensation paid to members of the company's governing bodies to be established in the articles of association.

The Ordinance leaves it up to each individual company to decide the granularity of detail that should be provided when describing the principles of variable and equity-linked compensation in the articles. As a result, there has recently been a debate in Switzerland among companies and investors concerning what level of detail is appropriate. Reportedly, many corporate consultants are advising companies to make these articles fairly general and vague in order to provide for maximum flexibility, while some shareholder advocates are pushing for companies to provide a greater degree of rigor in the articles, in particular with regard to equity-linked compensation.

We believe it is in shareholders' best interests for companies to propose principles that reflect the company's actual practices, with a reasonable level of detail that does not hinder the board's ability to make necessary adjustment.

Shareholders typically do not want to micromanage the company's affairs, and generally prefer to let the board design and implement the architecture of the company's compensation policy, provided they have the opportunity to express their views on the

company's compensation practices in an appropriate forum. This opportunity will be provided by the annual binding votes on board and executive management compensation.

However, shareholders tend to have certain basic expectations regarding how the remuneration of the board of directors and executive management should be structured: for example, that executives' remuneration should provide an appropriate link with shareholder value over the long term and should not reward failure, and that board compensation should reflect non-executive directors' primary oversight function and should not risk compromising directors' independence. It is therefore reasonable for shareholders to expect the articles to provide a basic structure for the compensation system that demonstrates alignment with shareholders' interests.

For example, details such as caps on variable remuneration and vesting terms for equity awards are regularly provided in Swiss annual reports and tend to remain relatively constant from year to year; establishing these structural elements in the articles would provide shareholders with assurance that these elements will remain well-structured going forward. At the very least, it is reasonable for shareholders to expect the articles to reflect the company's actual compensation practices.

ISS may therefore oppose overly vague or generic, boilerplate article provisions, particularly if there are existing concerns about the company's compensation practices. Moreover, ISS will oppose article provisions that explicitly include terms that are clearly not in line with its European policy on compensation.

### 2. Maximum number of external board mandates

The Minder Ordinance requires Swiss companies to set the maximum number of allowable outside board mandates for members of its governing bodies in the Articles of Association. According to the law, outside mandates refer to board mandates at listed and unlisted domestic and foreign entities outside of the group.

Many shareholders have raised concerns about the possibility that directors who serve on multiple boards may become overextended and may not be able to meet the time commitments required to fulfill their fiduciary responsibilities. By serving on multiple boards, directors may compromise their ability to serve as representatives to shareholders in the full capacity required in today's demanding governance environment. In order to avoid becoming overstretched, non-executive directors should avoid holding more than four additional non-executive mandates at listed outside companies. Likewise, executive directors should limit their outside mandates to no more than two non-executive directorships at listed companies, and non-executive board chairmen should hold no more than three additional non-executive directorships at listed entities. ISS considers executives or directors who hold a greater number of outside mandates to be "overboarded."

Cases of overboarding are relatively rare in the Swiss market. For example, board members at SMI Plus constituent companies had an average of 1.03 outside mandates at listed companies in 2013, and only about 2 percent of board members at SMI Plus companies had more than four outside mandates at listed companies. Therefore, provisions limiting non-executive directors to no more than four outside mandates at publicly listed companies appear reasonable in light of prevailing market practice.

In accordance with this policy, ISS will generally recommend against article amendments that permit non-executive directors to serve at more than four listed companies outside of the group, or which allow members of executive management to serve on the boards of more than two listed companies outside of the group.

In addition, ISS will begin applying its director overboarding policy for director elections at Swiss companies in 2015 following a one-year transition period. For Europe, ISS applies its overboarding policy to companies incorporated in markets where the local law or corporate governance code address the issue of overboarding, which is now the case for Switzerland following implementation of the Ordinance.

### 3. Loans, credits, and direct pension payments

The Ordinance requires an article amendment on the amount of any loans, credits, or pension payments outside of the workplace pension plan

allocated to members of the board of directors, executive management, and advisory board.

The issuance of loans or credits to executives or members of the board of directors is a fairly rare practice in the Swiss market, with the exception of companies in the financial services sector that provide loans and/or credits as part of their normal product offerings. The issuance of loans or credits to executives or board members may be a matter of concern for shareholders if the company appears to be granting loans excessively, at terms substantially different from those offered to normal customers, or (particularly in the context of the new Swiss legal framework) if the company appears to be granting loans or credits as a means of awarding compensation that avoids the scrutiny of a direct shareholder vote.

The practice of granting direct pension payments to former executives or board members is rarely seen in Switzerland, though there have been some cases of this in the past.

In general, ISS does not oppose the granting of loans or similar arrangements to executive management or members of the board of directors, although in the case of non-executive directors, loans that are not at market terms may constitute a material connection that compromises the director's independence. In such cases, the provision of the loan would be taken into account with respect to the director's independence classification and his/her election to the board. ISS will particularly scrutinize proposals seeking the flexibility to issue loans or credits by companies whose normal business does not include the provision of loans or credits, or where the company has not issued loans or credits to directors or executives in the past.

### 4. Additional remuneration for new members that join executive management

The Ordinance allows companies to specify a maximum amount of additional remuneration that could be paid to persons who join the executive management team after the shareholder resolution on aggregate remuneration. This would prevent the need for the company to call an EGM in order to obtain shareholder approval to pay new members of executive management.

There is a risk that the amount of money reserved in this article provision could potentially allow for excessive and unjustified payments, which shareholders would only find out about after the fact. On the other hand, it would not be in the company's or shareholders' interest to restrict the board's ability to hire new members of executive management. Moreover, the alternative to including this article provision would be to build a substantial buffer for new hires into the remuneration "budget" or prospective vote on executive management fixed compensation.

ISS will generally support proposals reserve a reasonable level of additional remuneration for new joiners.

## Direct election of board chairman and Remuneration Committee members

***How will ISS analyze these direct elections and apply policy?***

ISS will continue to apply its current policy for director elections at Swiss companies.

The Ordinance stipulates that the chairman of the board of directors and members of the Remuneration Committee are elected directly by shareholders. If the meeting agenda provides resolutions on board membership as well as separate voting items on the election of the board chairman and members in the Remuneration Committee, ISS will apply voting guidelines pertaining to the board chairmanship and membership on the Remuneration Committee to the specific resolutions concerning the election of the board chairman and members of Remuneration Committee, respectively. If nominees are only subject to one election (for example, if a candidate is nominated to both the board of directors and remuneration committee in one single voting item), then ISS will continue to apply all relevant voting guidelines to the board election item.

***Is it possible that ISS might provide differing voting recommendations on a nominee's election to the board and his/her separate election as board chairman or remuneration committee member?***

Yes. For example, if an executive is nominated to the board of directors and, in a separate election, as a member of the remuneration committee, ISS would generally recommend against the nominee's election to the remuneration committee, but would generally recommend in favor of the nominee's election to the board of directors, absent other concerns. This reflects the internal logic of the director elections policy, which is that the inclusion of executives on the board of directors may be acceptable, but that an executive's membership on certain key committees, such as the audit or remuneration committees, represents a clear conflict of interest which should be avoided. In the past ISS would have recommended against the nominee's election to the board, but under the new voting framework, it is possible to target the committee election specifically.

There are only a limited number of voting policies where ISS would potentially provide differing voting recommendations for a single nominee under ordinary circumstances (e.g. combined CEO/chair, low independence, or presence of executives on the remuneration committee). In most other cases, ISS will generally provide the same recommendation on the nominee's election to the board and his/her election as board chairman or as remuneration committee member. In no case would ISS recommend against a nominee's election to the board but in favor of his/her election as board chairman or member of the remuneration committee.

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