Switzerland

Michele Caratsch of Haymann & Baldi warns that legislators might be getting too carried away in their efforts to improve Switzerland's already world-standard governance regime

According to the independent pan-European study on corporate governance published by Heidrik & Struggles earlier this year, Switzerland has achieved the greatest overall improvement in its corporate governance implementation ratings since 2000, advancing from ninth to second place in the European rankings, placing it just behind the UK. The Swiss example shows that corporate governance practices can improve radically over a short period of time. The status of practical implementation of corporate governance principles has also been analyzed in the "Intermediary Report on Corporate Governance" published by the Swiss Business Federation on November 8 2004. This report confirmed that the existing Swiss corporate governance system already fully complies with the enhanced requirements and practices developed in other countries. This positive trend was anticipated in a study on the practical implementation of the Corporate Governance Directive of December 1 2003, commissioned by the SWX Swiss Exchange.

The positive grades arising out of these reports reflect the enthusiastic approach and the swiftness with which the discussion on corporate governance spread in Switzerland after the publication of the Hampel Report and of the Combined Code issued by the Hampel Committee on Corporate Governance in June 1998.

The basic principles embodied in the theory on balance of powers and division of authority, going back to Baron de Montesquieu, found their way into Swiss company law legislation enacted as early as 1992. The Swiss Code of Obligations introduced the principle of checks and balances between the various bodies of a company limited by shares, constituting the basic provisions for functioning corporate governance. But the Swiss approach was only thoroughly developed when, in 2000, a group of experts was entrusted by the Swiss Business Federation to prepare a report addressing the areas subject to improvement in the Swiss environment.

Taking advantage of earlier studies in the international context, the final Swiss report was able to quickly identify the basic flaws of the existing system and to suggest immediate measures to be taken for a quick improvement. What ensued was an initial set of recommendations on corporate governance for publicly listed companies: the Swiss Code of Best Practice, issued by the Swiss Business Federation and in effect since July 1 2002. These rules, issued on a purely self-regulatory basis, were supplemented by the Directive on Information relating to Corporate Governance (the CGD) issued by the SWX Swiss Exchange, laying out the minimum standards of information to be disclosed in annual reports published by publicly listed companies. Unlike the Swiss Code of Best Practice, which was based on the principle of non-enforceable recommendations, the CGD contains a set of mandatory rules for all companies admitted to the exchange, as the SWX Swiss Exchange derives its regulatory authority to enact the Directive from Article 8 of the Swiss Stock Exchange Act and Articles 1, 3 and 64 of the Listing Rules of SWX Swiss Exchange. There has been a flurry of legislative activities aimed at integrating and supplementing the scarce regulatory framework by adding certain provisions to the Swiss Code of Obligations to address three specific areas in which the self-regulatory approach was identified to be either insufficient or incomplete. In particular, legislative works have addressed, or are addressing, the following areas:

- disclosure requirements on the remuneration of the members of the board and senior management of publicly listed companies;
- new rules on statutory audits and qualification for the audit professions; and
- enhancement of protection of rights of minority shareholders, improvement of transparency in shareholding and for representation at shareholders' meetings.

So after a late and slow start, Switzerland appears to have become a model pupil in the international context, showing a continuous trend towards complete implementation of the basic corporate governance principles, both on a self-regulatory and legislative level.

Disclosure requirements on remuneration

Section 5 of the CGD makes it mandatory for publicly listed companies to disclose the compensation and participation of acting members of governing bodies. This includes members of the board of directors and of senior management. The CGD provides for global disclosure of the total amount received by executive board members and senior management and, separately, of the total amount received by non-executive board members. Severance payments made to the same circle of persons that become due during one given accounting year must also be disclosed.

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As of July 1 2005, the SWX Swiss Exchange enacted a further Directive on the Disclosure of Management Transactions (the MTD). The MTD aims to enhance transparency at management level by disclosing to the investor all financial transactions effected by management (as broadly defined in the CGD) in equity securities of listed companies, in which such persons fulfil a managing position, and that directly or indirectly affect or impact on their wealth.

The degree of transparency ensured by the combination of these two directives

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Caratsch's published work includes:

- "Privatisation in Uzbekistan" in *Privatisation & Public Private Partnership Review* 2005/2006;
- "New law drafted to integrate financial supervision" in IFLR's *Client Guide to Switzerland* (March 2004);
- "Privatisation in Tajikistan" in *International Privatisation Review* 2001/2002; and
- "Getting Injunctions and Freezing and Discovering Assets in Switzerland" in *International Commercial Litigation* (1999).

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did not seem to satisfy the requirements of the Federal Council, which opted to enhance transparency further by proposing to add some additional provisions to the Swiss Code of Obligations.

The resulting draft law, conceived as an amendment to the Swiss Code of Obligations, was published on June 23 2004. Despite criticism raised by, among others, the Swiss Business Federation, which questioned the actual need for such a legislative step, the lower chamber of Parliament passed the first draft unanimously early in 2005. The main changes to the existing regime under the CGD can be summarized as follows:

* The proposed draft law provides that the total sum of remuneration paid to the present and former members of the board of directors and of management, as well as to any person close to them, must be disclosed. In addition, the sums paid to each single member of the board of directors and the highest sum paid to a member of management has to be individually disclosed. The Federal Council has renounced individual disclosure of the sums paid to all the members of management. The justification was that their compensation is set by the board of directors so there is no danger of a conflict of interest.

- Additionally, any loan granted to leading members of management has to be disclosed.
- Lastly, any shareholding or participation in the company by members of the board of directors, of management or of any person close to them has to be individually disclosed. This latter provision is closely linked to the MTD issued by SWX Swiss Exchange.

One of the main criticisms raised against the present draft is that the widely flexible directives contained in the regulatory framework of the SWX Swiss Exchange will be crystallized into the stricter standards of the Swiss Code of Obligations, preventing a flexible approach to the issue. In particular, the disclosure of compensation paid to persons close to management, including consultants, who are bodies external to the company and as such not subject to a conflict of interest, as well as the disclosure of participations of former members of the board of directors and of persons close to them, appears to be unjustified and difficult to carry out in practice.

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The draft law is now in the upper chamber of parliament and might be subject to additional amendments before its enactment.

Rules on statutory audits and qualifications for the audit profession

On June 23 2004, the Federal Council published a new draft law to amend the Swiss Code of Obligations and enact a new federal law on the admission and state supervision of auditors. The legislative aim is to ensure a high quality of auditing procedures and to restore confidence in the auditing profession, which has been internationally shattered by recent scandals such as Enron and WorldCom. The internal controlling system, which includes the analysis of the checks and balances within a company, will become an integral part of the audit to be carried out by the external auditing body. The draft law has already passed the first hurdle constituted by deliberation in the lower chamber of the Swiss parliament. Astoundingly, the version submitted by the preparatory commission has been approved unanimously. It includes the following provisions:

* The auditors must check whether a company has a functional internal controlling system. The board of directors has a statutory duty to set up internal controlling mechanisms - this duty arises from its non-delegable and inalienable duty to provide for the administration of accounting, financial control and financial planning as laid down in the Swiss Code of Obligations.

- The auditor will have to determine whether the board of directors has carried out an adequate risk analysis. To do so, the auditors will have to review the relevant statements of the board of directors contained in the annex to the financial statements.
- In addition, the draft law states that the auditors will have to submit a complete report on their findings with respect to the company's accounting, the functionality of the internal controlling system, and the conduct and the results of their audit. This additional duty constitutes an enhancement of the present provisions under the Swiss Code of Obligations. As opposed to the draft of the Federal Council, parliament amended this

provision by limiting the duties of the auditors to commenting on the existence of an internal controlling system, without addressing its functionality. Whether parliament will uphold these restrictions is to be seen.

The professional qualification and independence of auditors will be secured by the new Act on the Admission and Supervision of Auditors. The draft act establishes a new supervisory authority, with an admission system that ensures that auditing services can only be rendered by qualified specialists. The same supervision will also be applied to auditing firms of listed companies. Under the Sarbanes-Oxley Act, Swiss auditing companies that audit companies listed on a US stock exchange are already subject to the supervision of the US Public Company Accounting Oversight Board. This voluntary submission to a foreign supervisory authority does not have a legal basis in the present system and could arguably fall foul of the provisions of the Swiss Penal Code, which prohibits in principle any unauthorized activity for a foreign state or authority on Swiss territory. The creation of a specific supervisory authority in Switzerland complies with international developments and requirements, and will grant Swiss auditing firms an easier approach to registration abroad or to supervision under foreign authorities.

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The introduction of internal control mechanisms that are audited by external auditors further ensures compliance with the whistle-blowing mechanisms introduced by the Sarbanes-Oxley Act, forcing companies to report any wrongdoings, even if discovered at a later point in time, and extending reporting duties to internal legal teams or external consultants such as law firms entrusted with capital transactions.

Scheduled amendments to Swiss Company Law

The Federal Council's legislative preparatory agenda has slated for December 2005 the publication of an additional amendment to the Swiss Code of Obligations for circulation and comments, aiming to further improve the transparency in the corporate life of Swiss companies, in particular regarding the exercise of shareholders' rights during general meetings. To promote the attractiveness of Swiss business and of the SWX Swiss Exchange, the legislative project will improve the flexibility of the capital structure of Swiss companies through the introduction of:

- shares without par value;
- an easier approach to the reduction of the share capital; and
- the complete dematerialization of share certificates.

Details of what will become part of the final draft are still sketchy. The Swiss Business Federation in its report of November 2004 identified a specific need for reform regarding the exercise of shareholders' rights, indicating that new shareholders' requests for registration and admission to vote at general meetings should be dealt with by Swiss companies swiftly, reducing the high number of shares that are held by banks in their deposits for various clients but that are not admitted to voting. The recent case of Unaxis Holding AG in April of this year, in which the results of the general meeting were effectively distorted by the board of directors' refusal to admit almost 20% of the share capital, which had changed hands shortly before the general meeting, confirms need for regulatory improvement in this area. Whether the Federal Council will adopt all requests formulated by the Swiss Business Federation is yet to be seen.

Banks and financial institutions

No review of the Swiss system would be complete without addressing the recent developments in the banking and financial sector. Banks, in particular the major institutions listed on the SWX Swiss Exchange, are primarily subject to the rules that apply to ordinary companies. The Swiss Federal Banking Commission, the supervisory authority on banks and financial institutions, has expressly stated that banks, due to their importance within the national economy, are meant to assume a leading role in implementing corporate governance rules. The present efforts focus on the implementation of an effective compliance risk management and have been formalized in two documents published in 2005. The subject matter they address somehow overlaps with the present regulatory efforts addressed by the Swiss parliament in the area of the revision of the rules governing auditing and internal control mechanisms.

In the international field, the Basle Committee on Banking Supervision recently issued the document "Compliance and the Compliance Function in Banks," providing a framework of principles for the banks' governance of compliance risk management. In Switzerland, the Swiss Federal Banking Commission has issued for consultation the draft of a new circular regarding internal surveillance and control, regulating the compliance function within a bank and the required independence of the bank's board of directors and of its audit committee.

The draft circular introduces a clear expectation that *compliance* is vested in a formal status within the bank and becomes a major topic both for senior management and the board of directors. It has to be set up on the basis of certain design principles typical for a compliance risk management organization. The management of compliance risk and its organizational set up must fit the company and be sufficiently organized to face the specific risk challenges of a banking organization. It further introduces a special regulated early warning system, which enables any employee to blow the whistle on suspected irregularities within the institute, by fully protecting the personality rights of the whistleblower and preventing the risk of retaliatory measures for their actions.

It appears that, despite the progress achieved in recent years, the discussion on corporate governance in Switzerland will not dry out soon, with the inherent risk that the enthusiasm developed on the issue might lead to a fully functional and apparently complete regulatory framework being supplemented, and allegedly improved, by substantial additional legislative action.