

Strengthening Risk Awareness and Accountability in Compensation Practices: Clawbacks

Globally, there has been an on-going trend to put risk alignment, conduct-related matters, and sustainability to the forefront of corporate activities – mainly driven by regulatory requirements and proxy advisor expectations. Clawbacks are considered one possible instrument in this context. They have been a common risk alignment tool among European banks and other financial institutions since their introduction in the EU regulatory landscape after the 2008 financial crisis. Most recently, in 2023, clawbacks became mandatory for executives of listed companies in the US.



A clawback is a mechanism for companies to reclaim vested and/or paid compensation awards that are already in the ownership of a beneficiary.

In comparison, a malus is applied to forfeit part of or all individual's compensation that has not vested and/or been paid out yet.

Market insights in Switzerland

While in other jurisdictions, including the US and the EU (merely for the financial industry), clawbacks are legally required, in Switzerland, the provision of a clawback is to some extent recommended¹ but not (yet) mandatory from a legal perspective. Still, large international proxy advisors already expect companies to have clawbacks in their toolbox for effective risk alignment.

In fact, clawbacks are more and more frequently observed in Switzerland with 29% of listed companies having clawbacks in 2021 vs. 22% in 2019. Notably, larger companies are at the forefront in this regard – potentially also because they are in the spotlight and under public scrutiny when it comes to governance best practices.

For example, around 80% of the SMI companies have this mechanism in place. In contrast, there are fewer medium and smaller companies which include clawbacks, but with a strong positive trend between 2019 and 2021 (SMIM: from 44% to 63%; SPI Mid: from 15% to 23%; SPI Small: from 8% to 13%).

Typically, clawbacks are foreseen for executives and majorly apply either to their entire variable compensation (51% of clawbacks), or solely to the long-term variable elements (44% of clawbacks). They usually enable the

Board of Directors to reclaim the relevant compensation elements for up to three years if certain trigger events occur, such as severe misconduct (61% of clawbacks), illegal activities (54% of clawbacks) or in case of financial restatements (49% of clawbacks).



Instruments

- 5% - Only short-term variable compensation
- 44% - Only long-term variable compensation
- 51% - Total variable compensation



Timing

- 3-year median validity period



Triggers (90% of companies disclose triggers)

- 61% - misconduct
- 54% - illegal activities
- 49% - financial restatements

Despite the focus and scrutiny by proxy advisors, some investors and the public, there are very few publicly known cases where a clawback was actually enforced in Switzerland. This can lead to the question: Are clawbacks an effective tool to achieve the goals regarding accountability and risk alignment mentioned above? Or is it like riding a toothless tiger?

Precedence in Switzerland

A Federal court decision from 2015 has provided some precedence for clawbacks. The main question to assess whether an award would be considered recoupable from a legal perspective is:

- Is the award considered a **gratification**, i.e., a discretionary element and **not a variable compensation element**?

This differentiation has actually been a challenge for labor law experts for a while, but the precedent case also offers some guidelines in this regard, along the following questions:

- How relevant is the variable part in the individual's overall compensation package on a relative basis and, specifically, does it exceed **five times the median Swiss salary**?

Depending on these conditions, a potential clawback is enforceable – given the pre-determined trigger conditions occurred.

¹ Clawbacks were for example discussed in the consultation exercise of FINMA when re-designing their corporate governance guidelines for banks in 2016.

International considerations for Swiss companies - SEC clawback application

In 2023, the Securities and Exchange Commission (SEC) in the US introduced a new clawback rule which will become effective on December 1, 2023. This rule applies to all listed companies in the US, incl. Swiss companies with a dual listing and foreign issuers. Under this rule, a clawback is required in case of a financial restatement of accounts which impacts any variable compensation granted, vested or paid out during the previous three fiscal years from discovery of the restatement. The recoverable amount refers to compensation that an Executive would not have been entitled to, had the financial statements been accurately presented.

Effectiveness beyond legal enforceability

Despite the Swiss Federal ruling in 2015, concerns regarding enforceability still remain. However, this does not mean that clawbacks are not effective per se.

A clawback could be considered to be most effective due to its preventive character, i.e., when it does not have to be enforced because a trigger event did not occur in the first place. Rather than looking at it as a punishment tool, a clawback could also be understood as a signal to employees that conduct and risk-aligned behavior is key for a company. The low number of cases of (public) enforcement might indicate a positive impact on risk alignment and prevented events that would have triggered clawbacks.

In this context, the determination of relevant trigger cases is key. While companies in other countries (especially in the US) are more limited by the prevailing rules and regulations, Swiss-based firms still have the flexibility to select the trigger events that are key in light of their individual risk management strategy. One fundamental consideration for decision makers in control functions is the following: Should the clawback be targeted towards conduct and compliance from a) an **individual** point of view, or should the approach be b) **collectively** based on risk management failures or restatements or should it be c) both?

In addition to its main benefit as serving as an effective preventive tool, there are other advantages.

In particular, clawbacks:

- put compensation at risk for longer which increases the alignment of interest with stakeholders;
- are deemed best practice from a corporate governance perspective to hold decision makers accountable;
- are increasingly aligned with market developments;
- are powerful for communication to comfort shareholders and other stakeholders that the company disposes of appropriate means under exceptionally adverse circumstances.

Complementary measures

Clawbacks are important elements shaping the risk culture of a company, but they should be accompanied by other relevant instruments and compensation design aspects. Research has shown that a clawback is most effective in terms of impact on risk when it is applied in combination with other elements.

Some examples throughout the entire determination process of variable compensation are: incorporating risk considerations in the funding approach, integrating conduct and compliance in the performance assessment process as well as installing deferral schemes, which may anyway be required from a regulatory perspective for many industries.

HCM's recap and point of view

In summary, clawbacks may bring many benefits:

- they are an effective instrument to align executives with stakeholders' interests;
- in addition to other design aspects, they are seen as a preventive mechanism that impact risk culture;
- they act as a safeguard in case the company needs to respond to a crisis such as fraud, misconduct, or financial restatements.

Key considerations in this regard for decision makers are:

- how can a clawback complement the measures we already have in place for our risk management and risk alignment?
- what are the adequate trigger events that are relevant for our envisioned risk culture, also from an accountability point of view?
- how do we communicate it internally and externally so that it unfolds its full potential?

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