Swiss stock index to reward ethical firms

The first Swiss stock exchange index dedicated to corporate governance will underweight companies that fall short of good practice

Vincent Kaufmann
CEO of Ethos Foundation, Switzerland

In the follow-up to its 20th anniversary, the Ethos Foundation in Switzerland has launched a new stock exchange index dedicated to corporate governance of Swiss listed companies in collaboration with the Swiss Stock Exchange (SIX Swiss Exchange).

The Ethos Swiss Corporate Governance Index (ESCGI) takes into account the main corporate governance best practice criteria in order to define the weight of the different constituents. This is the first index of its type on the Swiss stock market and allows investors to reduce the weight of companies that entail a corporate governance risk.

The Ethos Foundation has been active in the promotion of good corporate governance in Swiss listed companies since its creation in 1997. The integration of best practices in corporate governance has always been an integral part of Ethos' analysis of companies in relation to the construction of its investment funds. As a responsible investor, Ethos exercises the voting rights attached to its investments based on its voting guidelines that take into consideration internationally recognised best practices in corporate governance. In December 2016, Ethos published the 16th edition of its Proxy Voting Guidelines and Corporate Governance Principles. As part of its stewardship duties, Ethos engages in dialogue with listed companies with a particular focus on shareholder rights, board composition and board and executive remuneration.

> *The index is intended as an additional mechanism of self-regulation in listed companies, incentivising them to implement best practices in corporate governance*

The launch of the ESCGI is an innovative new way to promote good corporate governance in listed companies by privileging the companies that implement best practices. The respect of best practice in corporate governance serves as a reference for the weighting attribution to the companies comprised in the classic index of the Swiss market, the Swiss Performance Index (SPI). In fact, traditional indices are constructed based on the market capitalisation of each stock adjusted to the free float of the stocks. Apart from liquidity considerations, no specific rules drive the inclusion and weighting of a stock in standard indices.

Reduce corporate governance risks of passive investments

The past decade has seen a steady rise of passive investment by institutional investors. Passive investments usually have lower management fees and allow a close replication of the relevant stock index's performance. However, passive investments also imply that investors automatically invest in all constituents of the index and become captive investors. Investing in the entire market means that the portfolio of investors may include companies with poor corporate governance practices. The so-called 'exit strategy' is no longer an option for passive investors. Active ownership is the only way to influence companies to improve their practices.

In this context, Ethos believes that it is necessary to rethink the way traditional stock indices are calculated by adding further considerations. In particular, the ESCG Index aims to:

- Reduce the corporate governance risks by underweighting or excluding companies that do not apply best governance practices
- Reduce the carbon impact of the index by underweighting companies with significant carbon emissions
- Avoid overweighting companies that are under a serious controversy
- Avoid overweighting companies with a weight in the SPI exceeding 15 per cent
- Overweight companies that do not fall into one of the above categories

Focus on corporate governance risks

The criteria that are applied in order to measure the corporate governance risks are evaluated according to the Ethos Corporate Governance Principles, which are based on

MEASURING ETHICS
A new stock market index tells investors which firms are the best long-term ethical bet

corporate governance best practices. The index focusses on a selected list of corporate governance risks as an evaluation and weighting factor. The weighting of the different stocks can decrease to zero per cent compared to the standard index, depending on the intensity of the governance risks identified. In particular, the index focusses on corporate governance risks relating to shareholder rights, board composition as well as on board and executive remuneration.

Shareholder rights

Shareholder rights are paramount to the healthy functioning of a listed company. The index privileges companies respecting the one-share, one-vote principle. In addition, the duty to make an offer in the case of a change of control of more than 33.3 per cent of the voting rights must be respected as stipulated by the Swiss Financial Market Infrastructures legislation. In fact, the Swiss legislation allows companies to introduce in their articles of association the possibility to derogate from this obligation (so called 'opting out' clause).

The combination of multiple classes of shares and an opting out clause entails an important risk for minority shareholders. This combination might create an opportunity for the controlling shareholder to sell his stake with an important control premium at the expense of other shareholders. The buyer can gain control of the company with a small part of the capital and without having to make an offer for the rest of the capital. In such a case, the other shareholders who often represent the majority of the capital but the minority of the votes may see a new shareholder with potentially divergent interest taking control of the company. The impact on the valuation of the company can be substantial. The combination of multiple classes of shares and the opting out clause leads to a higher underweighting in the Ethos' index than each measure taken separately.

This scenario actually took place at the Swiss listed company Sika. The historical controlling shareholder with 17 per cent of the share capital and 53 per cent of the voting rights decided in December 2014 to sell its stake to the competitor Saint-Gobain. The articles of association of Sika included an opting out clause allowing Saint-Gobain to gain control without having to make a takeover offer. Saint-Gobain therefore offered an 80 per cent premium to the historical shareholder to acquire their stake. On the day of the announcement of the transaction, Sika's share price fell by almost 30 per cent. »

REDUCING THE RISK The Ethos index will underweight or exclude companies that do not apply best governance practice

However, the articles of association of Sika include a voting right limitation on the privileged shares, which were intended as a safeguard against a hostile shareholder taking control of the privileged shares. The historical controlling shareholder benefited from an exception to this limitation. Due to the announced change of control of the privileged shares, the majority of the board, who were not connected to the controlling shareholder, decided to remove the exception to the voting right restriction and strictly apply the articles of association. The controlling shareholder filed a lawsuit at the Zug Cantonal Court against this decision. On 28 October 2016, the court rejected the claim of the controlling shareholder. The latter has announced its intention to appeal this decision at Zug's higher court. The case is still pending, but it demonstrates the potential risk for investors when investing in companies that include such privileges for a single shareholder.

Board composition

The board composition is a central part of the governance of a company. In terms of composition, an adequate balance between size, independence, experience, diversity and expertise has to be reached. To ensure a balanced composition of the board, the board size should be sufficient but not excessive. However, in the Swiss market, several listed companies operate with a board of three or even two members. Apart from a Swiss law, which requires a minimum board size of one director, there is no listing requirement of a minimum board size. A board size of less than four members is a major risk for investors who are automatically invested in such companies if they want to replicate the standard index. The Ethos' index therefore underweights significantly companies with a board of less than four members.

The board should also include sufficient directors who are independent from management in order to carry out its supervision duties with objectivity and in the interests of all the shareholders. To be considered sufficiently independent, the board should include a certain number of independent directors.

In the case of companies with an important shareholder (or group of shareholders), the overrepresentation of important shareholders on the board is not desirable. This could lead to a major shareholder controlling not only the general meeting but also the board, which carries serious risks for minority shareholders and other stakeholders in the company. This is particularly important when the control of the company is obtained via a double class of shares.

Ethos' index underweights companies where the board lacks independence or where the controlling shareholder holds more than 50 per cent of the board seats.

In addition, the Ethos index will underweight companies with a combined chairman and CEO. Chairing a board of directors and running a company are two very important but distinct tasks. The separation of the offices of chairman of the board and chief executive officer is designed to ensure a balance of power. It reinforces the board's ability to make independent decisions and to monitor the conduct of business by executive management.

Board and executive remuneration

Particular attention has been paid to board and executive remuneration over recent years and has resulted in several new legislative measures worldwide. In particular, with the introduction of the Minder initiative, Switzerland is the country where the shareholders of listed companies have most rights with regard to voting board and executive remuneration. The shareholders now have the non-transferable right to vote on the total amounts of remuneration to be paid not only to the board of directors, but also to the executive management.

The design of the remuneration system is very important for three reasons. First, a remuneration system that yields excessive payouts is an important cost borne by the company's shareholders. Secondly, the remuneration system can strongly influence the attitude of managers toward risk taking, thereby impacting the strategic orientation of a company. Finally, an inappropriate remuneration system raises questions of internal fairness and constitutes an important reputational risk, which can compromise investors' trust and the motivation of employees.

Ethos' index focusses on two different practices that create a particular risk. The index underweights companies that grant stock options to their non-executive board members. This practice may significantly impair non-executive directors' ability to exercise their judgement in an independent way, in particular when the exercise period is approaching. The index also underweights companies where executive management systematically receives very high variable remuneration as a percentage of their base salary with poor connection to the performance of the company and the long-term value creation.

Characteristics of the index

In aggregate, compared to the standard SPI, Ethos' index overweights 76 companies, gives a neutral weight to six companies, underweights 97 companies and currently excludes 26 companies for major governance risk. Based on the backtesting made by Ethos, the index has a tracking error close to one per cent compared to the standard index and very close correlation.

This index therefore offers a robust alternative for investors wishing to track the market, while reducing the corporate governance risk of their investments. The index is also intended as an additional mechanism of self-regulation in listed companies, incentivising them to implement best practices in corporate governance.