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# *Executive Compensation & Corporate Governance*

*2010 survey examining  
compensation structure  
in SMI and SMIM  
companies as well as  
Say-on-Pay*

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# 1 The Survey

We are delighted to present the fourth edition of our survey “Executive Compensation & Corporate Governance”. The survey is one of the most comprehensive Swiss studies available on the level and structure of board and executive compensation for the years 2007, 2008 and 2009. This report provides a comprehensive picture of executive compensation for SMI and SMIM companies in Switzerland today, and we hope you find this breadth of perspective helpful.

In the light of difficult economic circumstances and an increasing shareholder activism we paid regard also to the recent developments in the practice of Say-on-Pay. Our 2010 issue covers the first analysis of how the Swiss stock market reacted to the “Abzocker-Initiative” (“Initiative against rip-off salaries”), which was later followed by the support of a major political party. Furthermore, we discuss the aspects of governing reward in today’s regulatory and economic environment. The remuneration committee’s remit is increasing, and compensation reporting needs to move from compliance to value-generating communication.

All data used in this survey is based on disclosed compensation information in the annual reports of the companies reviewed. We have not made any assumptions or adjustments to the disclosed values and methodologies used, in particular with regard to the variable compensation (valuation, vesting clauses, timing of disclosure and earning periods, etc.).

We trust you find the 2010 “Executive Compensation & Corporate Governance” survey an insightful and innovative read that presents answers to your key questions and provides ideas for addressing today’s reward challenges. As always, we welcome your feedback and hope to have the opportunity to debate these issues with you.



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## 2 Executive Summary

Building on the results from the surveys of the last two years, the 2010 issue of “Executive Compensation & Corporate Governance” examines the changes from 2007 and 2008 to 2009 in total compensation for the board of directors and CEOs. The key findings are:

- After a significant drop in compensation from 2007 to 2008, the pay level of chairmen of the board of directors of SMI companies increased from 2008 to 2009 and was in 2009 above the level of 2007. The median in 2009 was CHF 1.3 million, which reflects an increase of 10.9 % compared to 2007. For SMIM chairmen, though, the situation looks different: after an increase from 2007 to 2008 of the median compensation by 35.2 %, a consolidation occurred in 2009, when the median was CHF 560,591. Thus, the apparent convergence of the pay of chairmen of SMI and SMIM companies observed in 2008 did not continue in 2009.
- Compensation for other board members of both SMI and SMIM companies has remained stable in relative small bands for the years 2007 to 2009. No upward trend can be detected in regular board member pay, and the levels were relatively low (median compensation: CHF 317,407 for SMI and CHF 158,423 for SMIM companies).
- Fixed salaries of CEOs have remained relatively unchanged over the three years observed: the average CEO base salary has decreased by 8.7 % (SMI) and 8.8 % (SMIM) from 2007 to 2009. Variable compensation has reacted to the economic situation in a pronounced way, for both SMI and SMIM companies. The median CEO total compensation dropped significantly from 2007 to 2008 and increased slightly in 2009 for SMI companies. With CHF 5.9 million, the median total compensation in 2009 was still below the levels of 2007, though. Looking at SMIM companies, a significant drop also took place from 2007 to 2008, but no increase occurred in 2009; in fact, the median decreased further. Thus, the rebound in CEO compensation has been incomplete (for SMI companies) and non-existent (for SMIM companies).

- In 2008, at least 75 % of CEOs, chairmen and other board members suffered a net wealth reduction on their shareholdings due to falling share prices. In 2009, this situation was partially reversed due to the largely positive stock market development. The median wealth change for CEOs was CHF –900,000 for 2008 and CHF +480,000 for 2009. For chairmen, it amounted to CHF –1.0 million in 2008 and CHF +240,000 in 2009. For other board members, it was CHF –200,000 in 2008 and CHF +50,000 in 2009.

In this survey, we also put a spotlight on the governance of pay. A tectonic shift of the landscape of how pay is governed is, in fact, taking place. One particularly important development is the tendency for enhanced “Say-on-Pay” by shareholders. In Switzerland, this has become particularly salient through the “Abzocker-Initiative”. Arguments can be made supporting and denouncing such legislation. Opponents worry the bill will restrict the board and management and limit their ability to design effective compensation packages. Proponents argue that the bill further aligns owner-manager interests. It could also be argued that on balance the bill would not have any market impact.

Our results suggest that the stock market reacted in mixed ways to the announcement of the Initiative. On average, stock prices reacted negatively. Stock prices of the largest companies increased, while the decrease in stock prices of small and medium companies suggests that the market perceives the proposed regulation as value-destroying for these companies. The support for the Initiative by a large political party had little additional effect.

Apart from greater shareholder activism, another important development that we discuss is the enhanced remit of the remuneration committee of boards. Indeed, the ultimate responsibility of developing an effective and competitive compensation scheme lies with the board of directors. It is, therefore, important to have skilled and independently acting board members.

## 3 Survey Results

As a consequence of the Transparency Act which came into force in 2007, compensation data is now available for the years 2007, 2008 and 2009. In this section, we analyse and comment on the level and structure of compensation for chairmen of the boards of directors, other board members and CEOs for both SMI and SMIM companies.

### 3.1 Chairmen of the Board of Directors

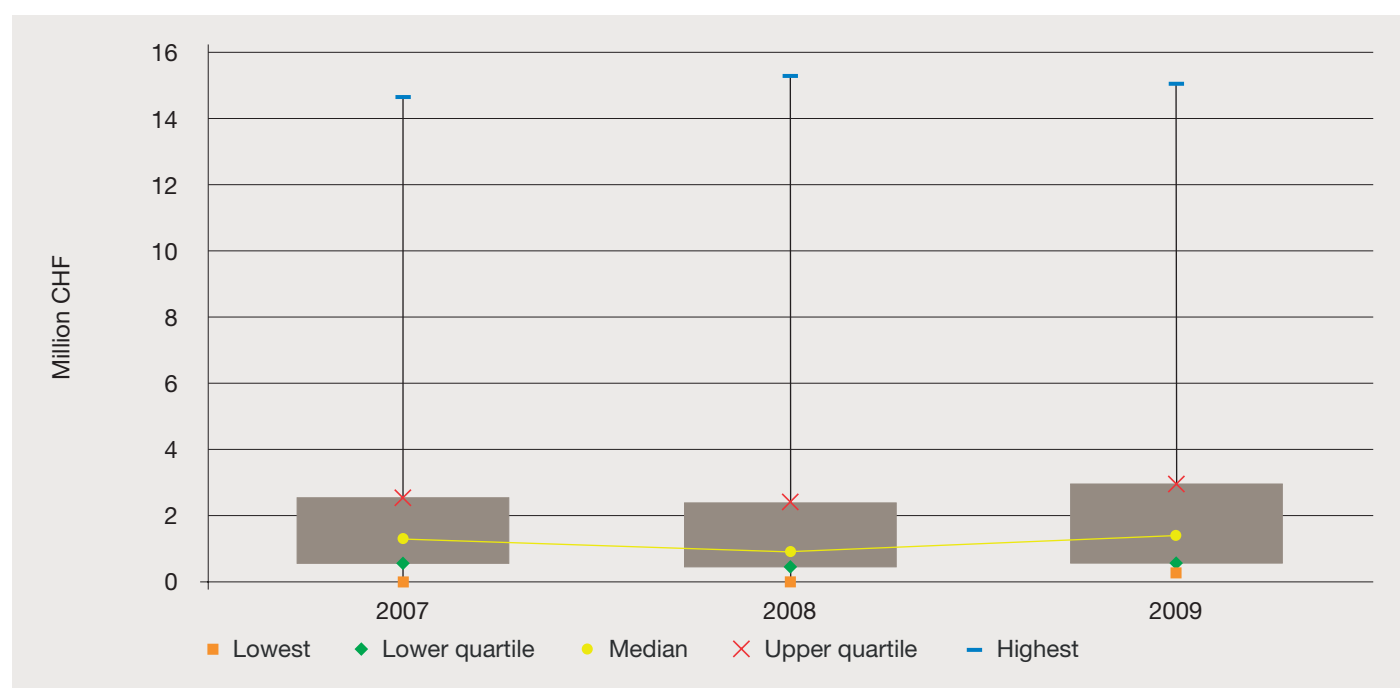
As the structure of the board of directors and the related responsibilities and tasks for members of the board of directors vary, for the chairman in particular, a one-to-one comparison among the SMI and SMIM companies proved difficult. Nevertheless, a comparison was made based on compensation data disclosed whereby only the non-executive chairman function was considered.

#### SMI companies

In general, the total compensation for chairmen has increased significantly from 2008 to 2009 after a drop in the previous year (except for the highest paid). The lower quartile for instance increased by 68.7% to CHF 670,599, the median by 57.6% to CHF 1.3 million, and the upper quartile by 28.5% to CHF 3.1 million. The average compensation amounted to CHF 3 million which is an increase of 21.8% compared to 2008.

After a drop of the overall compensation from 2007 to 2008, the figures of 2009 exceed the ones of 2007. Based on these findings it appears possible that compensation levels for chairmen are following a general upward trend, but it is, of course, too early to tell for how long this development will continue.

Figure 1: Total compensation of chairmen in SMI companies<sup>1)</sup>



<sup>1)</sup> Compensation for non-executive function (n=16)

### SMIM companies

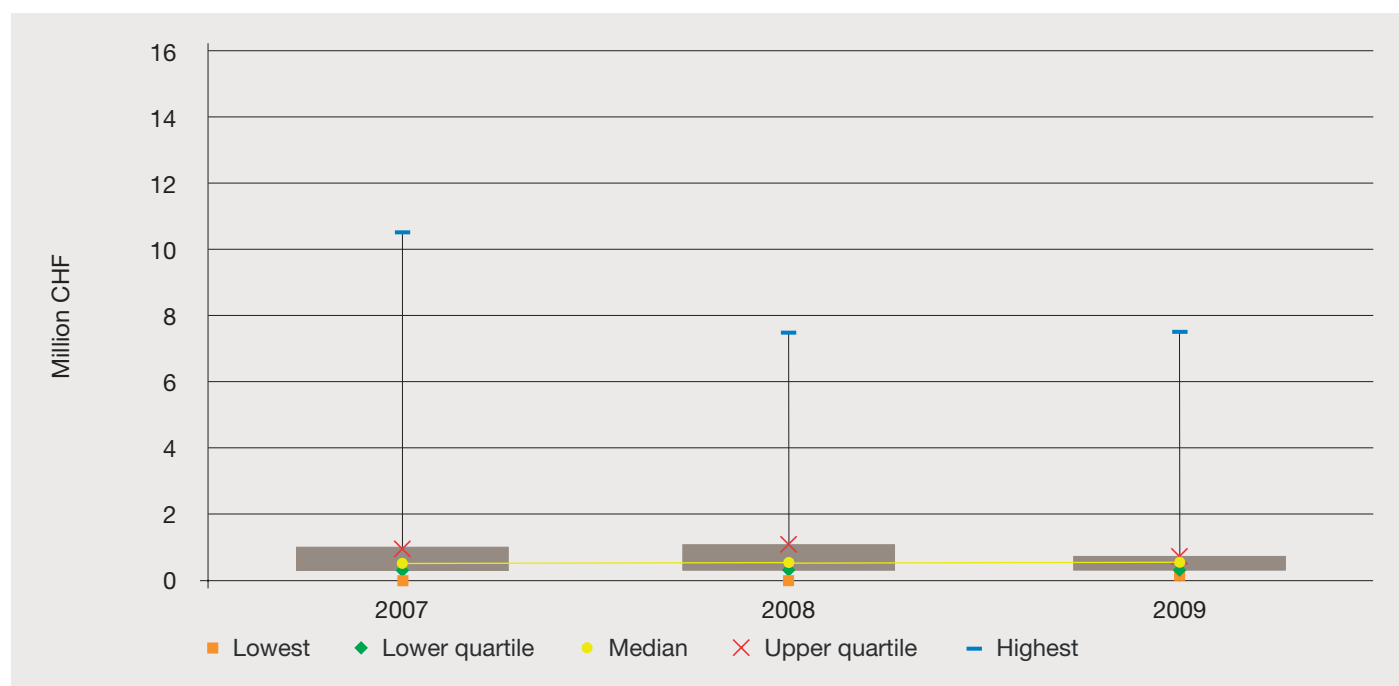
After a general increase from 2007 to 2008, the compensation levels remained relatively unchanged in 2009. Comparing 2007 to 2009, an ambiguous tendency can be observed:

- the lower quartile increased by 9.6 % to CHF 305,640 and the median by 30.2 % to CHF 560,591;
- the upper quartile decreased by 17.1% to CHF 751,464 and the highest paid by 30.2 % to CHF 7.4 million.

Thus, a convergence of compensation levels amongst SMIM chairmen has taken place.

Based on the developments from 2007 to 2008, it had appeared as if a convergence of compensation of chairmen of the board of directors of SMI and SMIM companies was taking place. The data from 2009 suggest that this was only a temporary development. In fact, the difference in medians in 2009 was almost exactly the same as it had been in 2007, about CHF 770,000.

Figure 2: Total compensation of chairmen in SMIM companies<sup>2)</sup>



<sup>2)</sup> Compensation for non-executive function (n=21)

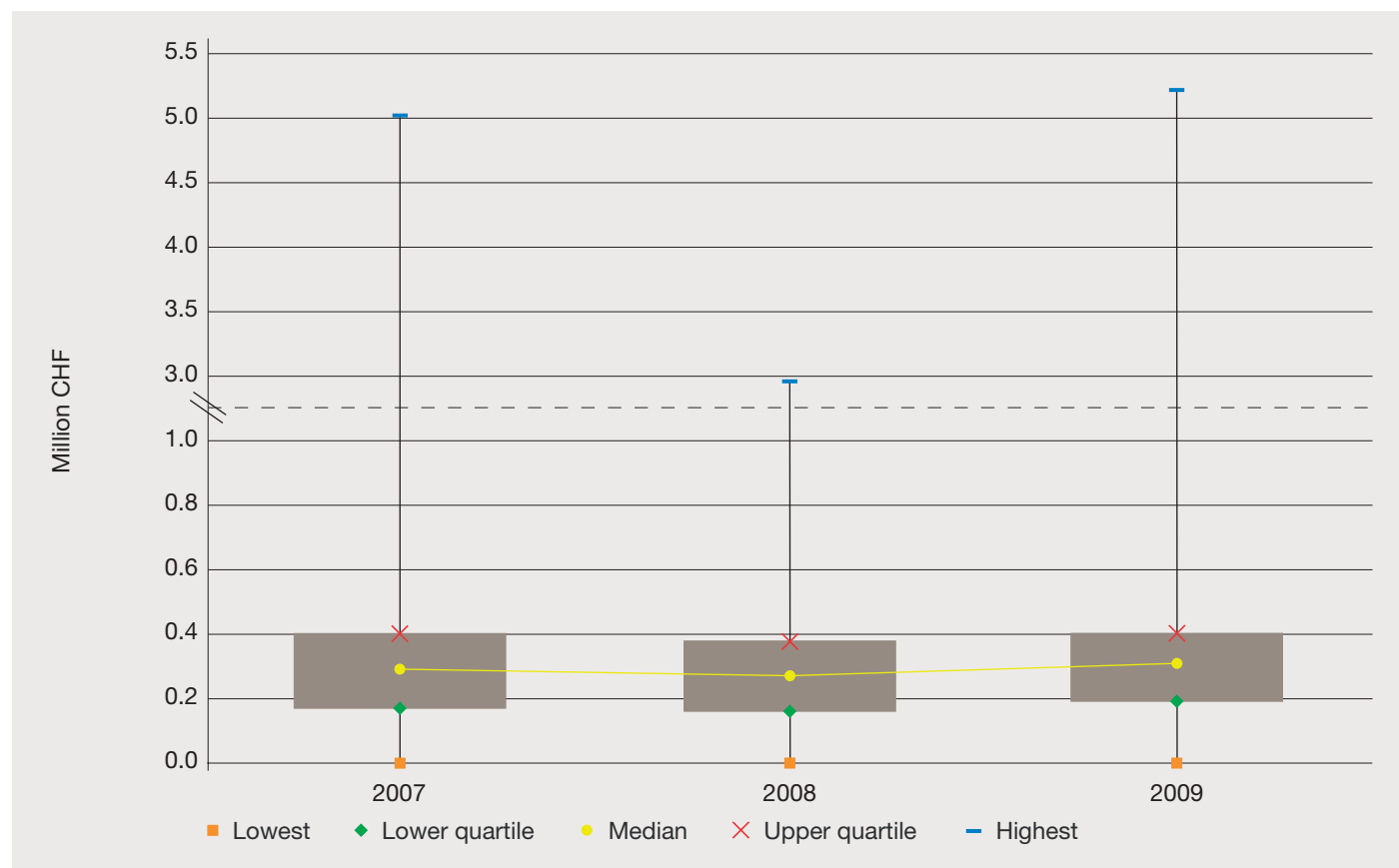
## 3.2 Other members of the Board of Directors

### SMI companies

The lower quartile amounted to CHF 192,799 and the upper quartile to CHF 400,034, i.e. half of the SMI board members were paid in this range for the year 2009. In 2007 this interval ranged from CHF 176,265 to CHF 400,000. The average increased from CHF 377,953 in 2007 to CHF 400,572 in 2009 (i.e. plus 6% in two years).

Based on these figures and trends we conclude that compensation levels of SMI board members have been stable in a relative small band for the years 2007 to 2009.

Figure 3: Total compensation of other members of the board of directors in SMI companies<sup>3)</sup>



<sup>3)</sup> Chairman and executive functions excluded (n=177)

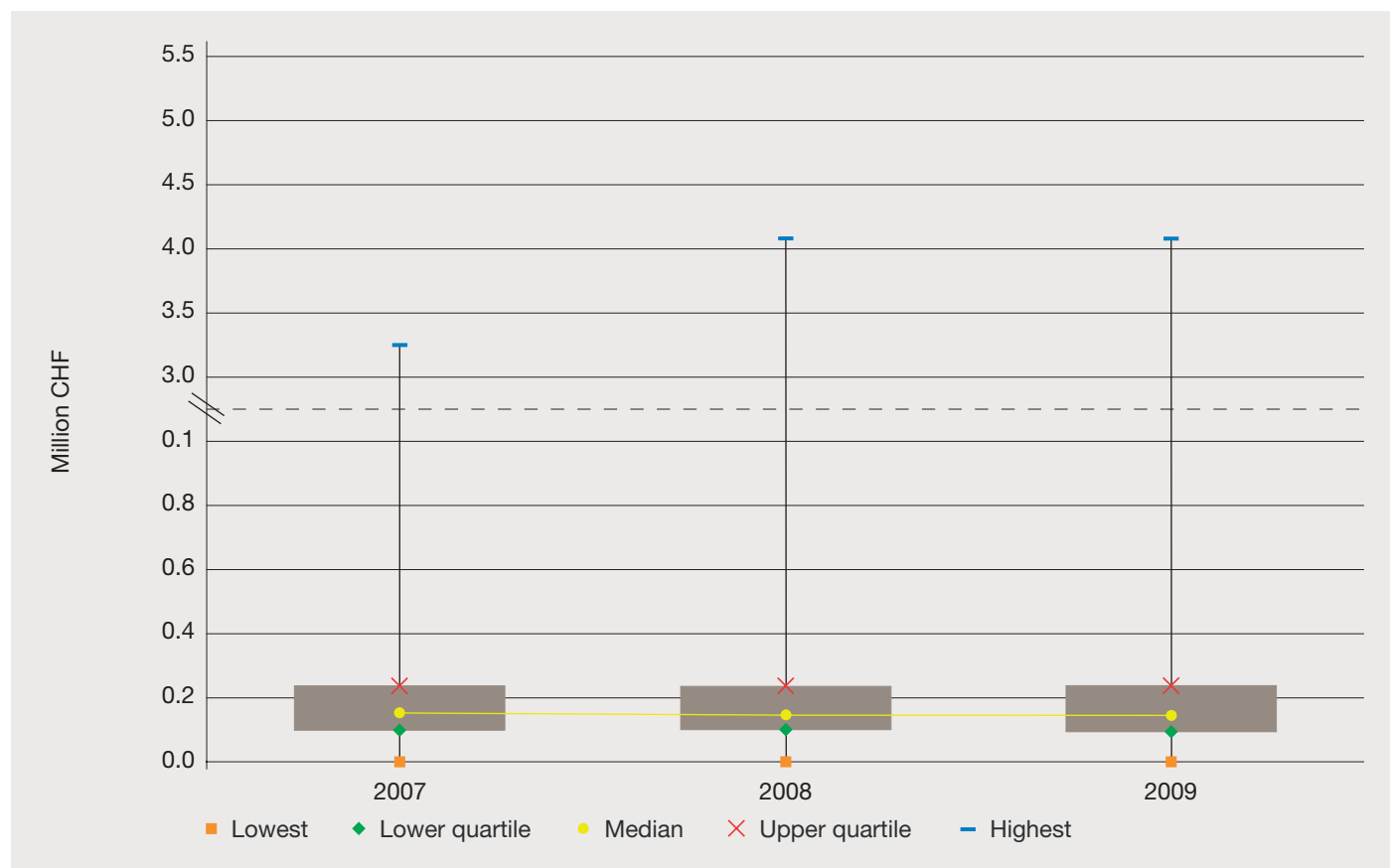


### SMIM companies

The lower quartile amounts to CHF 105,050 and the upper quartile to CHF 223,975, i.e. half of the SMIM board members were paid in this range for the year 2009. In 2007 this interval ranged from CHF 105,919 to CHF 221,000. The average decreased from CHF 248,103 in 2007 to CHF 230,052 in 2009 (i.e. minus 7.3 % in two years).

Based on these figures and trends we conclude that compensation levels of SMIM board members have been stable in a relative small band for the years 2007 to 2009. The overall picture of the development of compensation, therefore, is relatively similar for board members of SMI and SMIM companies.

Figure 4: Total compensation of other members of the board of directors in SMIM companies<sup>4)</sup>



<sup>4)</sup> Chairman and executive functions excluded (n=188)

### 3.3 CEOs

In this section we analyse and comment on the level of compensation for CEOs of SMI and SMIM companies. For both SMI and SMIM companies a drop occurred from 2007 to 2008. This downward trend has continued for CEOs of SMIM companies for the year 2009. By contrast, for CEOs of SMI companies, the drop from 2007 to 2008 was more significant than for SMIM CEOs. For SMI CEOs an increase occurred in 2009 compared to 2008. Even for them, though, the 2009 compensation levels were generally below those of 2007.

#### SMI companies

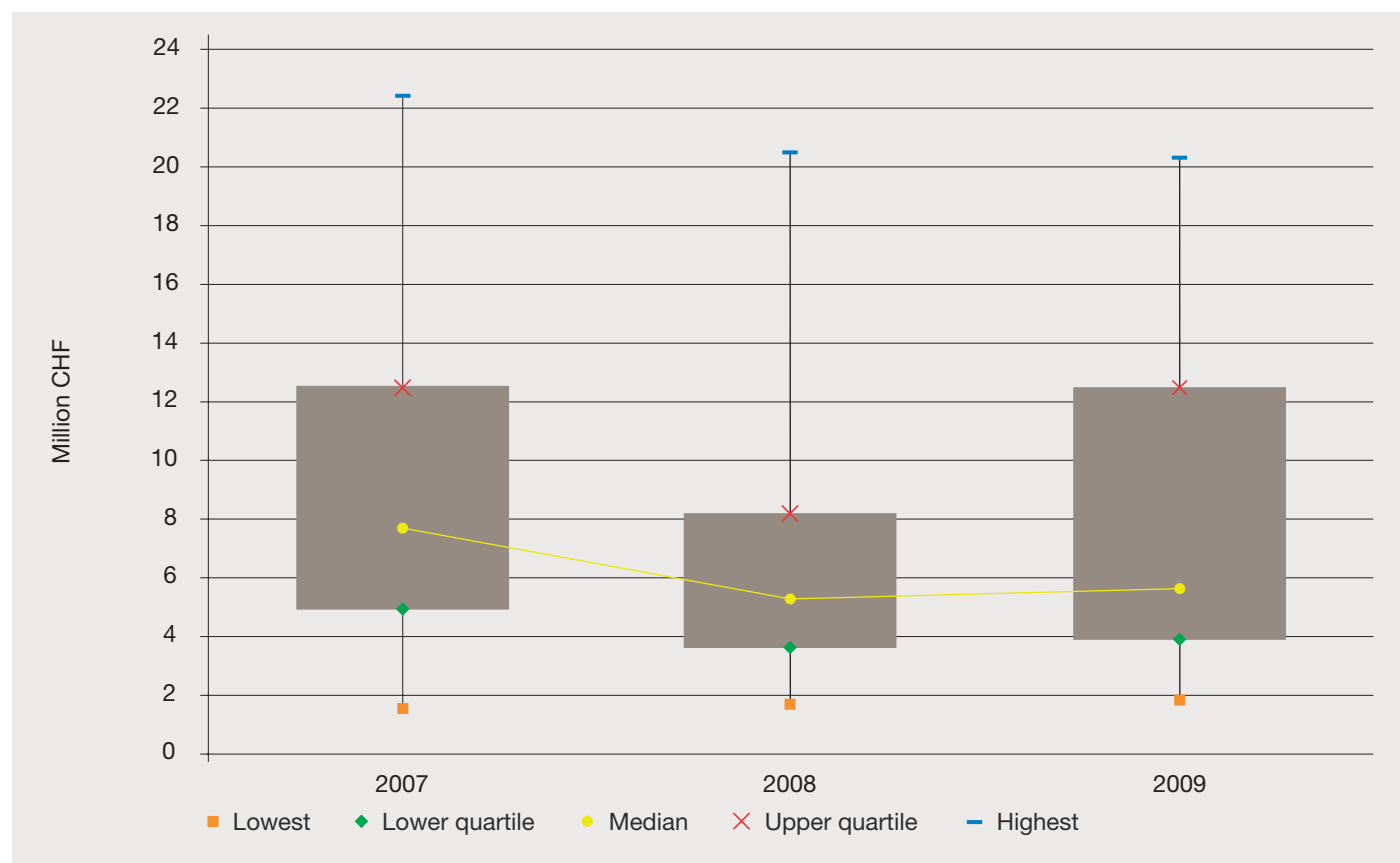
The lower quartile increased from 2008 by 4.4% to CHF 3.9 million, the median by 9.5% to CHF 5.9 million and the upper quartile by 52.9% to CHF 12.5 million for the year 2009. In comparison to the previous year the lower quartile and median

have remained relatively unchanged whereas the upper quartile increased significantly. Thus, the spread of individual total compensation has increased amongst SMI CEOs from 2008 to 2009.

In comparison to the year 2007, the 2009 median total compensation decreased by 24.2% from CHF 7.7 million to CHF 5.9 million and the average compensation 2009 decreased by 12.2% from CHF 9.3 million to CHF 8.2 million.

In sum, after a significant drop in 2008, a rebound occurred in 2009. However, compensation in 2009 did not reach the compensation levels of 2007 for CEOs of SMI companies. This is due to the downturn in 2008, overall volatile markets and a slow recovery of the economy during 2009. It is also possible that we are seeing the beginning of somewhat lower pay levels going forward.

Figure 5: Total compensation of CEOs in SMI companies<sup>5)</sup>



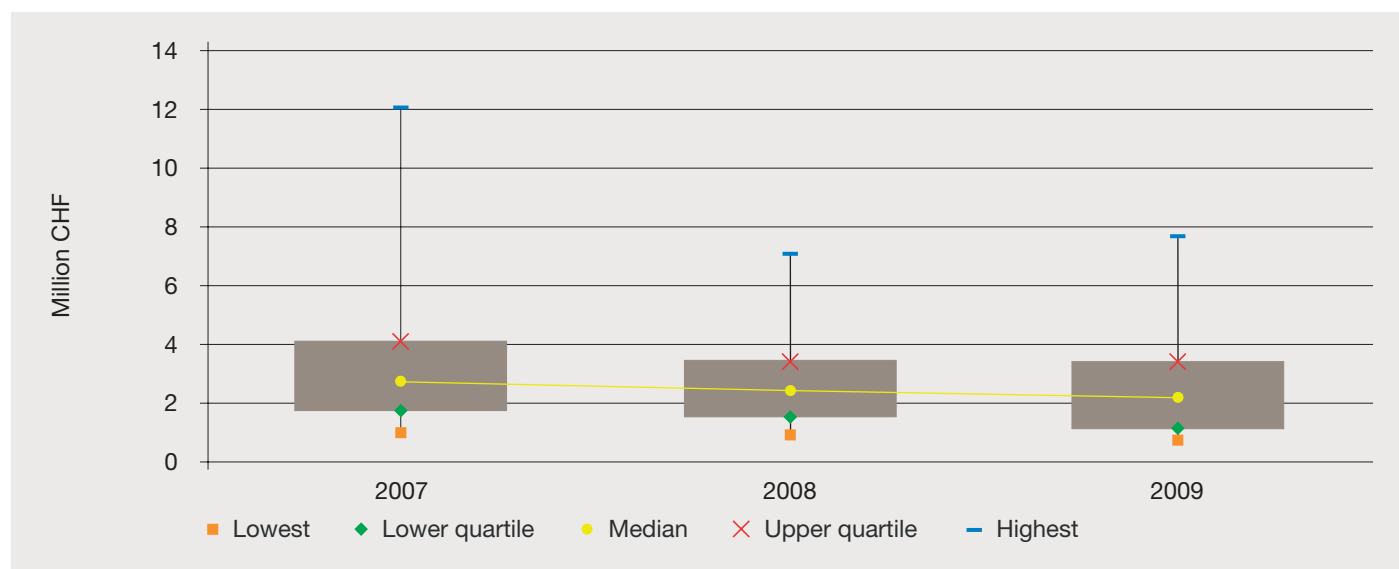
<sup>5)</sup> CEO or highest paid Executive Board member respectively (n=20)

### SMIM companies

The lower quartile decreased from 2008 by 12.5 % to CHF 1.4 million and the median as well decreased by 13.6 % to CHF 2.2 million. The upper quartile increased by 5.6 % to CHF 3.7 million and the highest paid by 11 % to CHF 7.8 million for the year 2009. At the same time, the average remained almost unchanged at CHF 2.9 million.

Compensation levels in 2009 were significantly lower compared to the year 2007. The average compensation 2009 was 22.7 % lower than 2007, i.e. it dropped from CHF 3.8 million to CHF 2.9 million. The median decreased by 20.8 % from CHF 2.8 to CHF 2.2 million. From an overall perspective, compensation levels of CEOs of SMIM companies have somewhat decreased over the period surveyed, i.e. from 2007 to 2009.

Figure 6: Total compensation of CEOs in SMIM companies<sup>6)</sup>



<sup>6)</sup> Chairman and executive functions excluded (n=28)

### 3.4 Structure of average total compensation of CEOs

Like in previous years, we have analysed the structure of the average total compensation for CEOs as we believe this provides important insights in addition to the analysis of the level.

#### SMI companies

As described earlier, the average total compensation increased by 18.0% from CHF 6.9 million in 2008 to CHF 8.2 million in 2009. This, however, happened, after a significant drop from 2007 to 2008 of 25.6%. Thus, the average total compensation overall decreased by 12.2% from CHF 9.3 million in 2007 to CHF 8.2 million in 2009, i.e. the current average CEO pay level is still below the figures of 2007.

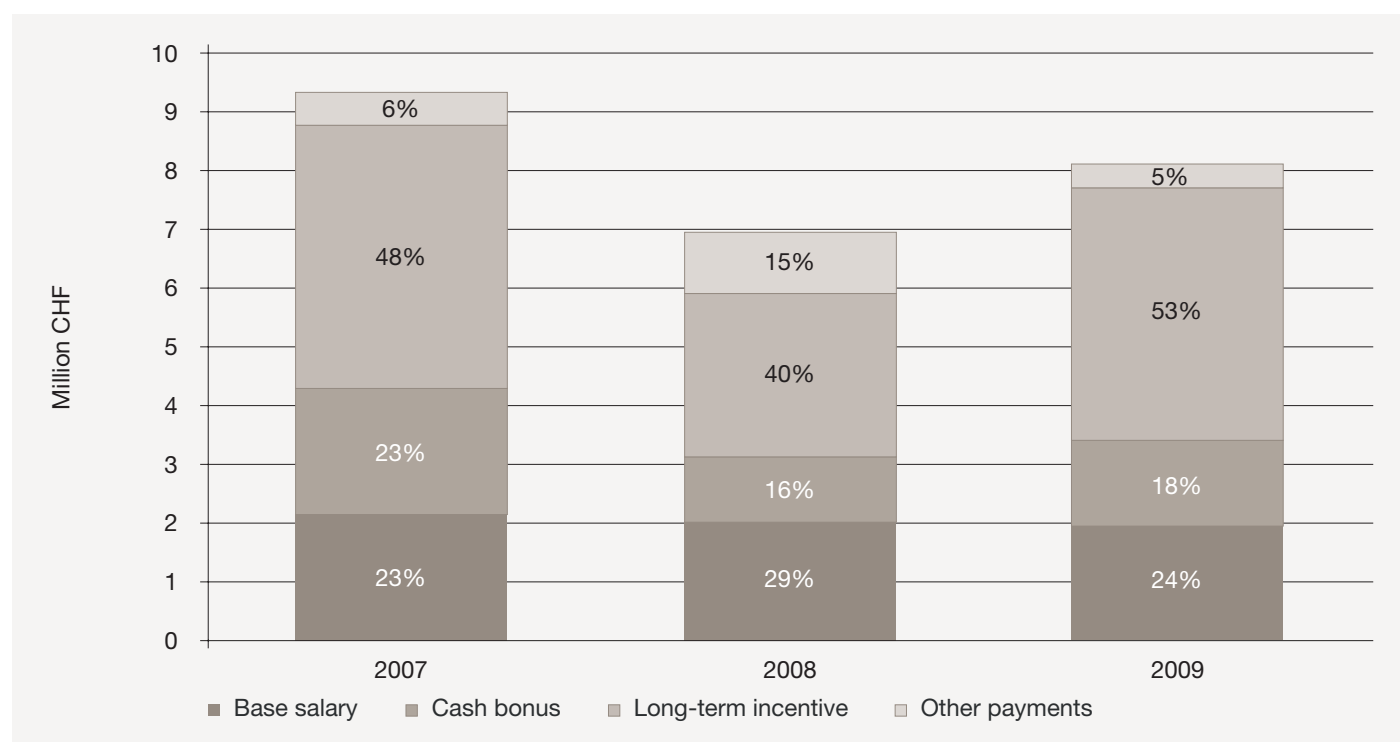
For 2009, the average total compensation was split into 24% base salary, 18% cash bonus, 53% long-term incentives, and 5% other

compensation. The base salary decreased slightly by 8.7% from 2007 to 2009 (CHF 2.1 million in 2007, CHF 2.0 million in 2008 and CHF 1.9 million in 2009), a somewhat surprising development.

The cash bonus dropped from CHF 2.2 million to CHF 1.1 million (–49.5%) and then increased to CHF 1.5 million (+33.8%). The cash bonus did not reach the level of 2007 (–32.4% comparing 2007 to 2009). The long-term incentives decreased from CHF 4.5 million to CHF 2.8 million (–38.6%) and then increased to CHF 4.4 million (+58.6%), returning almost to the level of 2007. The average other payments are relatively constant at 5% of total compensation, except an individual one-time payment which increased the average to 15% in 2008.

Based on these findings, it appears that the variable compensation has reacted to the economic circumstances. That is, it incorporated a significant reduction of total pay, mirroring the economic crisis of 2008, and then a moderate rebound in 2009.

Figure 7: Structure of average total compensation of CEOs in SMI companies



### SMIM companies

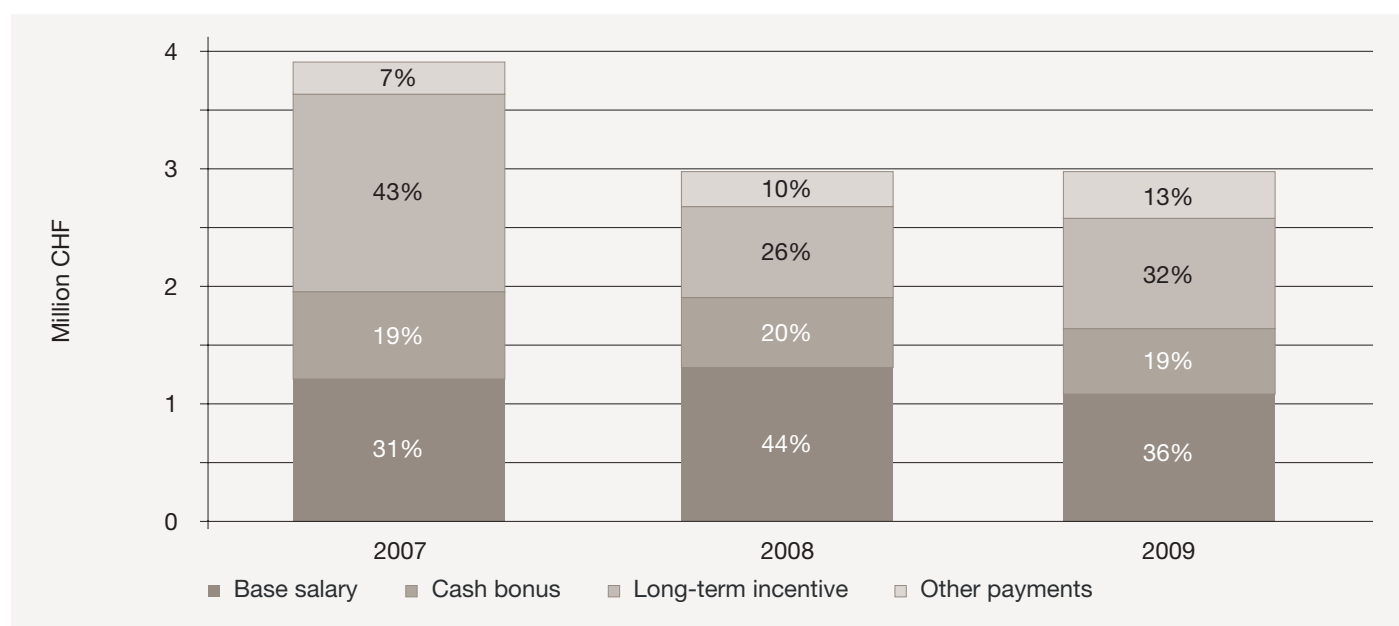
The average total compensation of CHF 2.9 million in 2008 remained unchanged in 2009. However, from an overall perspective, the average total compensation decreased by 22.7% from CHF 3.8 million in 2007 to CHF 2.9 million in 2009.

For 2009, the average total compensation was split into 36% as base salary, 19% cash bonus, 32% long-term incentives, and 13% other compensation. The base salary decreased by 8.8% from 2007 to 2009 and 16.7% from 2008 to 2009 (CHF 1.2 million in 2007, CHF 1.3 million in 2008 and CHF 1.1 million in 2009).

The cash bonus dropped from CHF 718,828 in 2007 to CHF 599,070 in 2008 (–16.7%) and then to CHF 562,634 in 2009 (–6.1%). The long-term incentives decreased from CHF 1.6 million in 2007 to CHF 774,094 in 2008 (–52.7%) and then increased to CHF 936,566 (+21.0%), returning almost to the level of 2007. The average other payments increased to CHF 383,962 in 2009 which reflects 13% of total compensation.

Based on these findings, it appears that the variable compensation has partially reacted to the economic circumstances. A significant reduction of variable compensation occurred due to the economic crisis of 2008. For the year 2009, despite a moderate economic rebound, the compensation level remained, however, unchanged compared to 2008.

Figure 8: Structure of average total compensation of CEOs in SMIM companies



## 3.5 Compensation structure 2009

Overall, the total compensation structure of 2009 within SMI and SMIM companies has not changed significantly compared to 2008. Board members were predominantly remunerated in the form of fixed compensation. Chairmen received about 60 % of their remuneration as fixed compensation, for both SMI as well as SMIM companies. Other board members of SMI companies received 88 % as fixed compensation whereas SMIM board members were provided with 72 % fixed compensation. While other board members of SMI companies received no LTI awards in 2009, SMIM companies remunerated the other board members with 14 % LTI awards. While other board members of SMI companies received no LTI awards in 2009, SMIM companies remunerated the other board members with 14 % LTI awards.

Within SMI and SMIM companies, the compensation of CEOs and other executives was structured in a similar way. Between the two samples, however, there were some noteworthy differences. In particular, CEOs and other executives of SMI received a lower fixed compensation ratio compared to the ones in SMIM companies. On average, the variable compensation exceeded for all executives the fixed compensation. Interestingly, within the variable compensation the LTI portion exceeded the cash bonus. This was particularly pronounced for the CEOs of SMI companies (53 % of total compensation) as well as for the other executives of SMI companies (42 % of total compensation).

Figure 9: Overview compensation structure 2009 in SMI companies

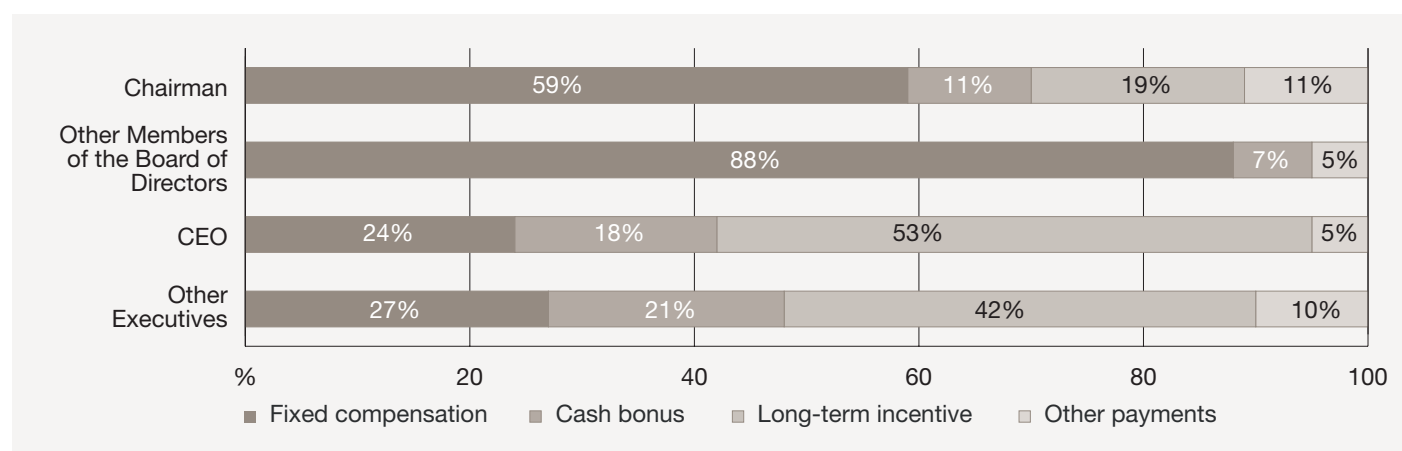
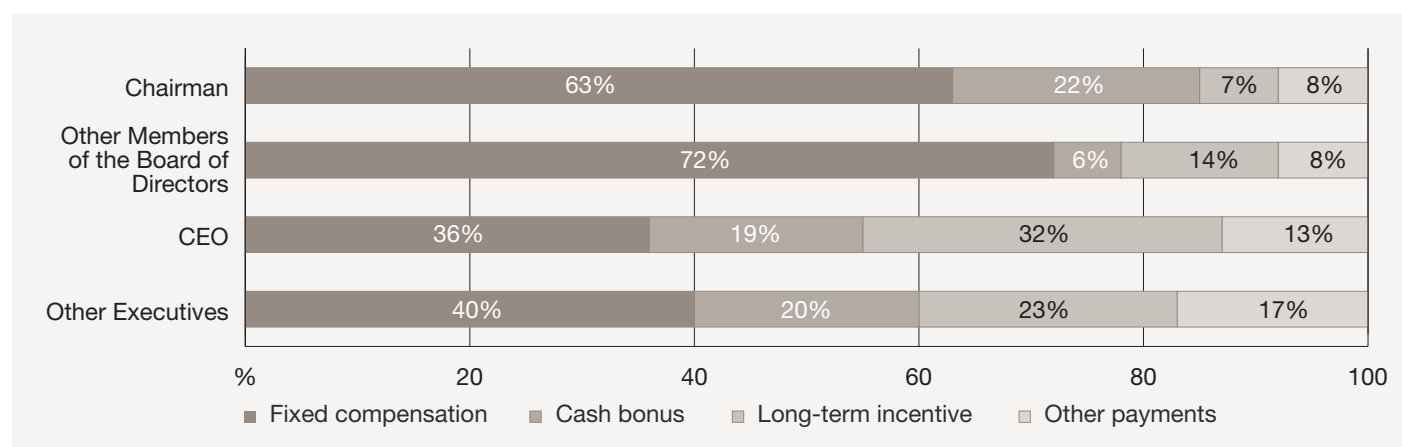


Figure 10: Overview compensation structure 2009 in SMIM companies



### 3.6 Wealth changes due to share ownership

In addition to analyzing the total compensation, it is also important to understand net wealth changes in the share ownership of board members and executives resulting from share price changes. These can be substantial in case of volatile markets. Table 1 lists these changes and developments. It is important to note that the highest gains and losses relate to chairmen and other board members that have significant share holdings (in particular as founders or founding family members).

In 2008, at least 75 % of CEOs, chairmen and other board members suffered net wealth reductions resulting from falling share prices. For 2009, however, the table reflects the mirror image, i.e. at least 75 % of the persons surveyed benefited from rising share prices. 50 % of all CEOs (between lower and upper quartile) benefited from share price increases in the amount of CHF 60,000 to CHF 980,000. In the previous year they suffered, however, a loss ranging from CHF 240,000 to CHF 2 million.

For chairmen, this range is wider: from CHF +10,000 to CHF +3.1 million for 2009 compared to CHF –35.6 million to CHF –300,000 in 2008. For other board members, this range amounts from CHF +7,000 to CHF +240,000 for 2009 compared to CHF –670,000 to CHF –60,000 for 2008.<sup>7)</sup>

The average wealth change of CEOs considered from end of 2008 to end of 2009 that is implied by their average shareholdings was negative: the average CEO lost CHF 550,000. However, the distribution is skewed; the median wealth change was, in fact, a gain in the amount of around CHF 500,000. (The skewness was more extreme in 2008.) The median share ownership in 2009 was around 0.035 % of the respective company. This shows a generally low share ownership quota of CEOs in their company. It means that a CHF 1,000 change in shareholder wealth in a given year corresponds to CHF 0.35 CEO wealth change. All the numbers reported in this section do not reflect implied ownership through options or other instruments similar to equity. They are merely based on what companies report to be the direct alignment of their CEOs with shareholders through the ownership of shares.

**Table 1: CEO and board of director wealth changes in the years 2008 and 2009 due to ownership<sup>8)</sup>**

2008	Highest gain	Top 25 % (upper quartile)	Median	Bottom 25 % (lower quartile)	Greatest loss
CEOs	+230,000	–240,000	–900,000	–2,000,000	–220,000,000
Chairman	+6,340,000	–300,000	–1,000,000	–35,600,000	–2,745,000,000
Other Members of the Board of Directors	+42,830,000	–60,000	–200,000	–670,000	–3,015,000,000
2009	Highest gain	Top 25 % (upper quartile)	Median	Bottom 25 % (lower quartile)	Greatest loss
CEOs	+10,300,000	+980,000	+480,000	+60,000	–35,400,000
Chairman	+2,170,000,000	+3,100,000	+240,000	+10,000	–30,000,000
Other Members of the Board of Directors	+1,440,000,000	+240,000	+50,000	+7,000	–318,000,000

<sup>7)</sup> At one company, three board members have a shareholder agreement regarding a large stock package. In our 2008 analysis, shown in the top table, we had attributed the wealth change on the whole stock package to one individual. In the 2009 analysis, shown in the bottom table, we divided the total effect by three to account for the agreement between these three shareholders.

<sup>8)</sup> All amounts in CHF and rounded. Wealth changes in 2008 are calculated as the difference between the wealth due to the average of the reported stockholdings on 31 December 2007 and those on 31 December 2008, valued on 31 December 2008, minus the value of these average shareholdings on 31 December 2007. For wealth changes in 2009, the same methodology is applied. All shares (not only vested shares) are considered. Companies that do not report shareholdings for the respective category of individuals are not considered in this table.

## 4 Shareholders and compensation (Say-on-Pay)

The headlines and editorials of the popular press are filled with criticisms objecting to excess in executive pay. Of the stakeholders affected, shareholders have the most immediate rights to influence the pay-setting process. In the past, they had de facto delegated decision-making on compensation matters to the board. However, many critical observers propose that shareholders should reassert their power. To put this in perspective, it is instructive to consider some global evidence on this matter. The PricewaterhouseCoopers Global Equity Incentives Survey (available on request) covers around 320 companies around the world. In this data, we observed a declining trend from 2005 to 2009 of companies putting compensation plans to a shareholder vote (though part of this trend may be due to sample composition changes). At the same time, where votes are held, the general approval rate has also come down. Some countries (such as Australia, the Netherlands, Norway, Sweden, and the United Kingdom) require shareholder votes on executive compensation.

### 4.1 Views on Say-on-Pay

Like in many countries, Say-on-Pay is controversially and emotionally discussed in Switzerland. We believe, however, that especially in a debate as heated as the one on managerial compensation, rational thought deserves a place. To organize thinking, the arguments relating to the say-on-pay initiative can be categorized into three hypotheses: the alignment, interference, and neutral effect hypotheses.

The alignment hypothesis proposes that say-on-pay will better align owner-manager interests and improve governance and performance. Allowing shareholders to have a say in executive pay may help reduce the agency costs between executives, directors, and shareholders, result in more efficient compensation contracts, and add value to the firm. This may be especially relevant for large companies, as in their case the collective action problem for shareholders and the entrenchment possibilities of managers may be particularly pronounced. To avoid the embarrassment of a low approval vote on executive compensation, management may be more willing to start dialogues with shareholders and listen to their concern. Another advantage that practitioners we work with sometimes highlight is that having to explain a compensation system to shareholders and win their (advisory) approval forces the board and executives to really think through the system.

By contrast, the interference hypothesis argues that the Say-on-Pay initiative will be disruptive. Opponents argue that the current pay practices of most companies are efficient and there is no need for the government to regulate the process of determining executive compensation. They further argue that the bill will distract the board and management and reduce the authority of the board. Moreover, they worry that proposals will be divisive or driven by special interests or extremely small shareholders.

Third, historically there has been little market impact surrounding the announcement of or voting on shareholder proposals. This may be because the votes are symbolic or because management generally does not adopt these proposals even when they receive majority votes. This is the neutral effect hypothesis.

### 4.2 The impact of Say-on-Pay on shareholder value

Switzerland has not introduced Say-on-Pay in a binding or advisory manner. However, in 2006, the so-called “Abzocker-Initiative” (“Initiative against rip-off salaries”) was launched by Thomas Minder. This Initiative covers a lot of ground. Also, the Initiative may not be exclusively designed to foster shareholder value, but it may also target some social goals. But Say-on-Pay is an essential element of the Initiative, and it is, therefore, interesting to evaluate the shareholders’ perspective on the proposed regulation. Specifically, the launch of this Initiative provides a natural experiment to examine whether shareholders’ votes on executive compensation in particular, and access to the proxy in general, add value to a company. The Swiss version of Say-on-Pay would involve binding votes (as opposed to the advisory votes relevant in the U.S. or the U.K.).

To investigate this question, we employ a well-established statistical method called “event study”. The logic of this method is simple. On the day of a particular event, one can see whether the stock of a company reacts in “abnormal” ways. The benchmark of the “normal” return is given by a model of how the stock would typically develop; such predictions are relatively reliable on average over the short run. The difference of the actual stock price development from the predicted development then is the so-called abnormal, or surprise return. If this return is large and sufficiently precisely estimated, a significant causal effect of the event on the stock price has been found.



In the present case, we consider two events whose causal impact on stock prices we evaluated: the first important step was made on February 26, 2008, when entrepreneur Thomas Minder publicly announced that more than 100,000 signatures in favour of his “Initiative against rip-off salaries” had been collected. Per Swiss law, this meant that the proposed bill of Mr. Minder was set for a public vote. The second event of interest took place on February 10, 2010, when a large political party (the SVP) announced the indirect backing of Mr. Minder’s bill. In fact, they suggested that an even more stringent stock corporation law should be enacted, replacing the public bill proposed by Mr. Minder.

### **4.3 Event study on Swiss stock market reaction**

When analyzing how the market reacted to these initiatives, we found interesting results (for details please refer to the pertaining Table 2 in the Appendix). Consider first the total effect for all of the around 220 SPI companies for which the required data was available. Value-weighting the individual stock return effects according to the market capitalisation of the respective company implies that there was a small, positive effect of +0.11 % of the “Abzocker-Initiative”. From this perspective, the Initiative could be seen as an immediate success. If, however, the SPI companies are equally weighted, a negative effect of –1.34% results. This effect is statistically significant. Put in another way, a significant majority of companies were negatively impacted by the Initiative.

These results can be explained by noting that theory suggests that there may be different effects for big and small companies. To explore this possibility, we analyzed the reaction within five size quintiles, i.e. considering separately the group of the bottom 20 %, the next 20 %, and so on in terms of market capitalisation at the time of the event. The striking result is that the on-average negative reaction was, in fact, concentrated in the (relatively) small to medium companies, whereas the quintile of the largest companies (roughly the 40 largest Swiss companies) benefited. Value-weighting the individual effects, we estimate that due to the “Abzocker-Initiative” the 20 % largest companies gained CHF 2.9 billion in market value, whereas the small to medium companies together (80 % of the companies studied) lost roughly CHF 1.7 billion in market value.

When the SVP joined in, it seems there was little extra effect on the stock market.

### **4.4 Concluding remarks on Say-on-Pay**

Taken together, the evidence suggests that a Say-on-Pay bill may not benefit all firms. Of course, some uncertainty surrounds these estimates. Also, it is possible that the stock market reacted to elements of the “Abzocker-Initiative” that had nothing to do with Say-on-Pay. For example, the stock market reaction may react on a general fear of regulation. But for all practical purposes these results suggest that the “Abzocker-Initiative” created value for the shareholders of the biggest companies but destroyed, rather than created, value for small to medium companies. We interpret these results as implying a warning call for the latter set of companies that they need to have appropriate procedures in place in order to deal efficiently with what the stock market appears to see as interference by regulation. By contrast, the market appears to think that for large companies the benefits of binding Say-on-Pay, perhaps due to better alignment of managers with shareholder value, will outweigh the costs.

## 5 Governing Reward

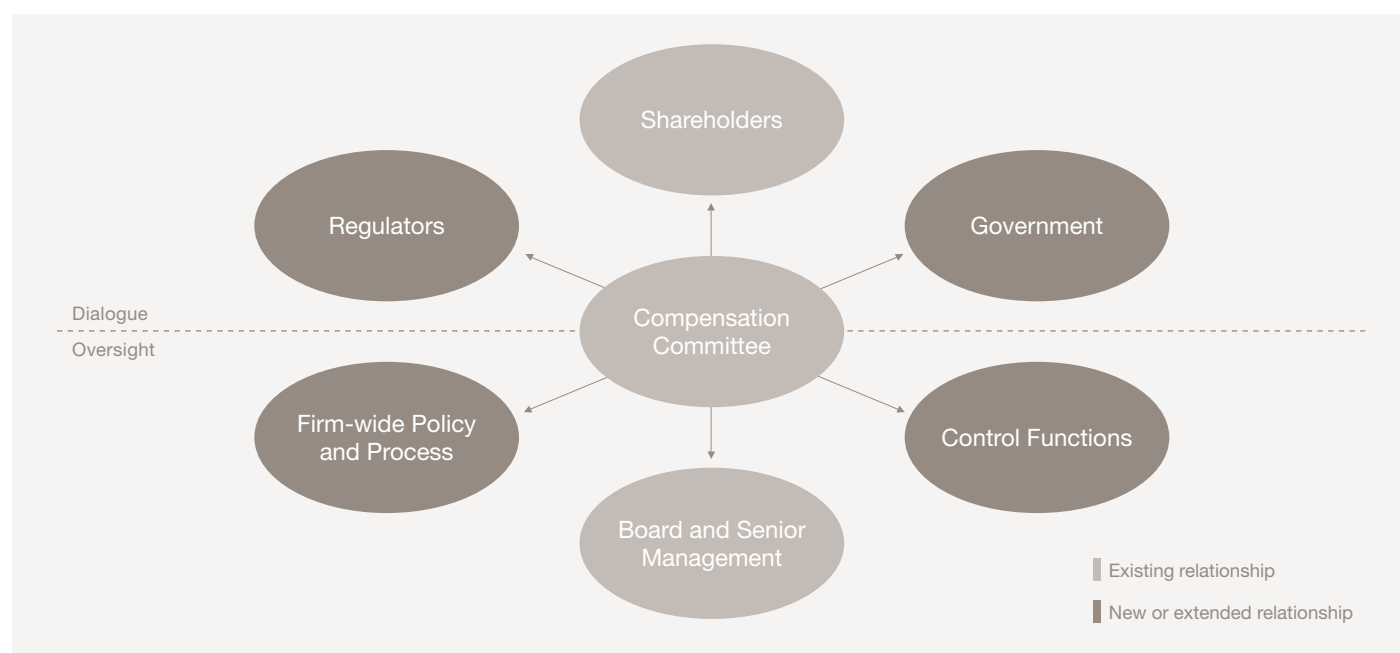
In this section, we put the spotlight on a few developments in the area of reward practice that we regard as particularly relevant for those firms and managers wishing to prepare themselves for the long term. This discussion is brief, but we are happy to engage with you on each of these points.

- 1. Payment of non-executive directors is likely to occur more in the form of equity than in the past.** In fact, empirical evidence (for the US) clearly documents that equity-ownership of directors is causally related to superior performance of companies. One important concern, though, is that directors with performance pay may be “too well” aligned with management’s interests and too dependent in particular on the CEO. For example, directors may engage in excessive earnings management or even manipulation, and they may be more willing to be “flexible” with compensation arrangements. Clearly, strong board members and boards are needed to avoid such pitfalls.
- 2. True board strength is different from pro forma board independence.** Indeed, the evidence that independence of directors per se has much to do with firm performance is weak as we discussed in last year’s Survey. Detailed analysis of a large sample of financial institutions reveals that it was, in fact, banks and other institutions with the most independent

directors who had the highest write-downs in the course of the financial crisis. But evidence exists that more competent directors (of financial institutions) have helped their companies survive the crisis better. We predict that board competence is going to remain a major theme of the future and indeed that it will become even more important.

- 3. The Compensation Committee’s remit is expanding.** As illustrated in Figure 11, not only does the Compensation Committee have to work with the rest of the board and with shareholders, but it is also increasingly involved in interactions with regulators, the government, control functions in the firm as well as with firm-wide policy formation and processes.
- 4. Each company needs to define its own preferred way for allowing the Compensation Committee to actually decide on these expanded remits.** A number of scenarios are conceivable. One entails the creation of a compensation oversight committee with representation from key control functions. This committee could support the Compensation Committee with its increased remit and responsibilities. It would review the design and outcomes of divisional and individual incentives, recommend to the Executive Committee some design changes and adjustments, and report findings of

Figure 11: Interactions of Compensation Committees



reviews to the Compensation Committee. Another scenario would be to establish Divisional Compensation Committees who authorise remuneration below the Executive Committee level. These Divisional Committees could be staffed by divisional managing directors, group human resource and risk officers, and possibly externals. While a meaningful division of labor in some sense, it is possible that such a setup would lack clarity against the group Compensation Committee's remit, and there could be issues of consistency across divisions. It may also unnecessarily inhibit management's ability to use compensation as a management tool.

##### 5. Compensation reporting needs to comply with new regulatory standards and to support value-based management.

Reporting should be part of a strategic approach to shareholder engagement, and it needs to cover rationale as well as facts – “disclosure and analysis”. Evidence is accumulating that companies with high-quality voluntary disclosure actually offer superior long-term performance for shareholders, at least up to some point. In short, compensation reporting is a key element of building shareholder trust. In addition, for companies listed on the Swiss Exchange SIX, transparent and clear disclosure is vital, as the SIX has announced that in its review of company reports 2010 (as already in 2009), it will pay particular attention to whether

the quality criteria required by the Directive on Information relating to Corporate Governance by the SIX are, in fact, fulfilled. As a recent case has highlighted, the SIX intends to vigorously enforce compliance with this directive.

**6. Designing suitable total compensation structures is challenging** due to a variety of complex influence factors (including regulatory and legal restrictions, shareholder pressure, expectation of management, volatile markets, war for talents, demographic developments, etc.). Total compensation systems consist of several parts (see Figure 12) and must be closely aligned to the business strategy and must support long-term sustainable value creation. For example, we may witness a rise of performance-dependent pensions as an important element of pay. The new EU rules on compensation put in place in July 2010 (which for the time being cover financial institutions only) entail the possible requirement to convey part of pay in the form of instruments whose value is tied to the overall value of the company. It is too early to tell the impact in practice e (e.g. legal enforceability and local pension law) but we urge companies to remain watchful on this matter. Structuring and balancing of the different elements of total compensation will continue to be of vital importance in order to gain and sustain competitive advantages.

Figure 12: Elements of total compensation: Best practise consideration

Ownership: alignment through holding of equity investment (skin in the game)	Share-based compensation	<ul style="list-style-type: none"> <li>• Participation in the long-term sustainable value creation (prospective view)</li> <li>• Enforcement of corporate culture and business strategy</li> <li>• Alignment of interests of shareholders and management through ownership</li> </ul>
	Bonus	<ul style="list-style-type: none"> <li>• Short-term retrospective performance measurement (quantitative and qualitative goals)</li> <li>• Risk adjustment and use of non-financial metrics (including discretion)</li> <li>• More long-term oriented (deferred mechanism and bonus bank)</li> </ul>
	Base salary	<ul style="list-style-type: none"> <li>• Fixed compensation element, representing market value of function</li> <li>• Functional grading system serving as basis for total compensation system</li> <li>• Stronger focus on base salary</li> </ul>
	Pensions & Social Security	<ul style="list-style-type: none"> <li>• Important remuneration element (long-term wealth accumulation)</li> <li>• Pressure on funding of liabilities (asset performance and ageing of society)</li> <li>• Social security planning and compliance</li> </ul>
	Fringe Benefits	<ul style="list-style-type: none"> <li>• Tailored and tax-efficient offering</li> <li>• Cost control</li> </ul>

## 6 Concluding Remarks

The heated political debate has spurred regulators into action, both in Switzerland and globally. The past year has seen the Swiss Financial Market Supervisory Authority (FINMA) publishing guidelines on minimum standards for remuneration systems of financial institutions. Most recently, an Initiative has been launched (and at least partially supported by political parties) that would, if put into law, implement the most strict version of binding Say-on-Pay in any major country. We suggested in last year's Survey that there seems to be a tendency to overregulate compensation matters in Switzerland, and we continue to stand by this assessment. While a regulatory framework is needed, it should not be too restrictive. Otherwise, companies will not be able to develop and operate compensation systems which are competitive in the market and support sustainable long-term performance. The evidence that is offered by the study of the stock market reaction to the current Say-on-Pay Initiative in Switzerland supports this view.

Apart from considering regulatory aspects, it continues to be essential to consider compensation systems in the context of an overall picture. The right compensation system for a particular company depends directly on its business strategy and the environment in which it operates. A balanced compensation system is one that offers long-term incentives, is geared to strategic objectives, and includes risk-taking in the evaluation of performance and results.

The ultimate responsibility of developing such compensation systems lies with the board of directors. It is therefore essential that the members of the board of directors have the required competencies and are not only formally independent but also act in such a manner. This is a cornerstone of good corporate governance. It ensures the right principles are set and implemented, and adherence is monitored. We believe that the following six principles are central to success:

1. Only a strong board can implement an effective total compensation system.
2. The incentive system must be designed as a "best fit" with company strategy – and it needs to be communicated as such.
3. Compensation should be linked to a few key performance indicators (KPIs), but not exclusively to easily controllable factors.
4. Limits to pay are not required for well balanced compensation systems.
5. An effective compensation system establishes entrepreneurial incentives.
6. An effective compensation system focuses on value created for the long term.

# Appendix

## A) Companies surveyed *(in alphabetical order)*

### SMI companies

ABB  
Actelion  
Adecco  
Credit Suisse  
Holcim  
Julius Bär  
Lonza  
Nestlé  
Novartis  
Richemont  
Roche  
Société Générale de Surveillance  
Swatch  
Swiss Life  
Swiss Re  
Swisscom  
Syngenta  
Synthes  
UBS  
Zurich Financial Services

### SMIM companies

Aryzta  
Bâloise  
Barry Callebaut  
Basilea  
Clariant  
EFG International  
Galenica  
GAM  
Geberit  
Georg Fischer  
Givaudan  
Helvetia  
Kühne & Nagel  
Lindt & Sprüngli  
Logitech  
Nobel Biocare  
OC Oerlikon  
Panalpina  
Pargesa  
Petroplus  
PSP Swiss Property  
Schindler  
Sika  
Sonova  
Straumann  
Sulzer  
Temenos  
Valiant

## ***B) Methods and additional results for the analysis of the impact of Say-on-Pay***

We highlight here some of the features of the analysis of Say-on-Pay offered in the main text. Further technical details and results (including robustness checks) can be found in the study underlying the summary here.<sup>9)</sup>

The event study methodology employed in this study is a simple and widely-used method. The basic idea, as described in the main text, is to identify the causal effect of an event on stock prices by calculating, with the use of a model, how stock prices would have developed, and then taking the difference to the actual development. The difference in the change, labelled “abnormal return” can then be attributed to the event.

As for every event study, the crucial point is to carefully examine and define the date at which a significant event took place. It is important to determine which milestones are likely to have the largest impact, as they were the least expected and most important. In the present case, a national keyword search in the vast news database of LexisNexis for the time period of July 2006 to March 2010 was conducted. Although several events potentially are related to Say-on-Pay, the two events chosen for this study are the most significant ones: the first important step was made on February 26, 2008, when entrepreneur Thomas Minder publicly announced that more than 100,000 signatures in favour of his “Initiative against rip-off salaries” had been collected. Per Swiss law, this meant that the proposed bill of Mr. Minder was set for a public vote. The second event of interest took place on February 10, 2010, when a large political party (the SVP) announced the indirect backing of Mr. Minder’s bill. Also, we confirmed that they do not suffer from potentially confounding news that took place on the same day. Most importantly, the announcement that more than 100,000 signatures in favour of Mr. Minder’s “Initiative against rip-off salaries” had been collected, came as a surprise (at least more so than the typical legislative development which proceeds in widely discussed steps).

Our sample consists of all the companies that were listed in the SPI during the respective event window and that had a long enough price history to cover the estimation window. After exclusion due to the latter reason, we ended up with 219 and 220 firms for the first and second window, respectively.

To determine the market reaction on the specified date, we used data of the official daily closing prices of the SPI constituent companies as available on the Thomson Datastream database. We first used data from 250 days up until two days before the event to estimate a model of share price movements that relates returns on stocks to returns of the overall market (the SPI). This is in the spirit of the Capital Asset Pricing Model. With this standard approach, we calculated predictions of what the returns on each stock should have been in the event window, i.e. on the day of (and the day immediately before and after) the relevant event. This is the so-called normal return. Taking the difference between the normal return and the actual (observed) return yields the abnormal return for each stock that is due to the event. Besides a single stock-by-stock consideration, we investigated the relation between company size and compensation levels on the one hand and abnormal returns on the other hand by aggregating the firms into suitable quintile portfolios. For these calculations and for the measurement of the monetary impact of the Initiative, we collected data on the free-float adjusted market value of the SPI companies, i.e. the market capitalisation.

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<sup>9)</sup> Wagner and Wenk (2010), Say-on-Pay in Switzerland, University of Zurich, 2010, available at [www.pwc.ch/reward](http://www.pwc.ch/reward).

The main results were described in the text. Table 2 presents some more detailed results.

**Table 2: The impact on the Swiss stock market of Say-on-Pay Initiatives**

	February 26, 2008 “Abzocker-Initiative” passes 100,000 signatures hurdle	February 10, 2010 SVP announces backing of “Abzocker-Initiative”
A. Average reaction of SPI companies (equal-weighted)	<b>-1.34%</b> [-1.81%; -0.88%]	<b>-0.54%</b> [-0.95%; -0.12%]
B. Total effects: value-weighted reaction in CHF Million for the 5 size quintiles separately		
Quintile 1 (smallest)	-8.93 [-29.71; +11.85]	<b>-21.62</b> [-31.06; -12.18]
Quintile 2	<b>-92.27</b> [-116.14; -68.40]	-5.97 [-85.50; +73.77]
Quintile 3	<b>-270.51</b> [-359.38; -181.64]	-78.13 [-242.02; +93.78]
Quintile 4	<b>-1,326.76</b> [-1,935.02; -718.51]	34.48 [-453.82; +516.82]
Quintile 5 (largest)	<b>+2,936.96</b> [+2,411.66; +3,462.26]	-226.73 [-965.7; +786.95]
C. Total effect: value-weighted reaction in % during three-day event window	<b>+0.11%</b> [+0.07%; +0.16%]	-0.03% [-0.23%; +0.16%]
D. Total effect: value-weighted reaction in % during three-day event window for quintiles 1 to 4	<b>-2.32%</b> [-3.07%; -1.58%]	-0.13% [-1.34%; +1.08%]

Notes: The table shows announcements effects in the event window (-1/+1) days within the respective event. The numbers are surprise effects, i.e. they net out the expected return or market capitalisation change and, therefore, show the causal effect of the two events. Numbers in square brackets describe the 95 % confidence intervals. If an interval has both positive and negative numbers, this means that the effect is not statistically significant from zero at a 95 % confidence level. Effects that are statistically significantly different from zero are highlighted.

First, as shown in section A of Table 2, the average surprise return of all SPI companies together was strongly negative, at  $-1.34\%$  on the first date and  $-0.54\%$  on the second date. These effects are statistically highly significant. These are unweighted averages; that is, these numbers provide insight into how an investor who held a portfolio with all companies in the SPI in identical proportions fared on the respective dates. Put another way, this reflects the fact that a significant majority of companies reacted negatively.

Next, one might expect different effects for big and small companies. Therefore, we analyzed the reaction within five size quintiles, i.e. considering separately the group of the bottom 20%, the next 20%, and so on in terms of market capitalisation at the time of the event. In section B of Table 2, we present the surprise market capitalisation change in the event window where within each quintile we also weight the companies by their size. Intuitively, this corresponds to an investor holding companies in the proportion of (roughly) the SPI index. The striking result is that the on-average negative reaction is, in fact, concentrated in the small to medium companies: whereas the quintile of the largest companies (roughly the 40 largest Swiss companies) benefited. We estimate that for this group roughly CHF 1.7bn ( $= 1.33 + 0.27 + 0.09 + 0$ ) were lost on the stock market due to the launch of the “Abzocker-Initiative”. Our results also imply that a bigger amount, CHF 2.9 bn, was gained for the largest companies. When the SVP joined in, it seems there was little extra effect on the stock market when considering value-weighted results (except in the group of the smallest companies); see the right-most column.

These findings are brought together in parts C and D of Table 2, where we consider the results in percentage terms. Considering all of the SPI, value-weighting the results (according to size) implies that there was a small, significantly positive effect of the “Abzocker-Initiative”. On the other hand, when looking at all the companies except the biggest 20%, we find a statistically and economically significant value destruction due to the first event, on the order of 2.3% of the market capitalisation. We note that analyzing the impact around this particular day is likely to understate the economic significance of shareholders’ say on executive pay. After all, neither the launch of the “Abzocker-Initiative” nor the help of the SVP guarantee implementation into law.



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Chairman	SMI			SMI Changes			SMIM			SMIM Changes		
	2007	2008	2009	07/08	08/09	07/09	2007	2008	2009	07/08	08/09	07/09
Upper Quartile	2,568,379	2,388,785	3,070,609	−6.99%	+28.54%	19.55%	906,043	932,560	751,464	+2.93%	−19.42%	−17.06%
Median	1,200,000	844,723	1,330,867	−29.61%	+57.55%	10.91%	430,500	581,876	560,591	+35.16%	−3.66%	+30.22%
Lower Quartile	520,869	397,564	670,599	−23.67%	+68.68%	28.75%	278,750	261,000	305,640	−6.37%	+17.10%	+9.64%
Highest	14,624,000	15,228,951	15,116,196	+4.14%	−0.74%	3.37%	10,625,656	7,418,000	7,418,000	−30.19%	0.00%	−30.19%
Average	2,328,611	2,424,636	2,954,167	+4.12%	+21.84%	26.86%	1,231,812	906,415	862,602	−26.42%	−4.83%	−29.97%
Lowest	0	0	256,570	0.00%	n/a	n/a	0	0	144,000	0.00%	n/a	n/a

Board of Directors	SMI			SMI Changes			SMIM			SMIM Changes		
	2007	2008	2009	07/08	08/09	07/09	2007	2008	2009	07/08	08/09	07/09
Upper Quartile	400,000	375,053	400,034	−6.24%	+6.66%	+0.01%	221,000	218,217	223,975	−1.26%	+2.64%	+1.33%
Median	296,030	279,869	317,407	−5.46%	+13.41%	+7.22%	169,000	154,500	158,423	−8.58%	+2.54%	−6.26%
Lower Quartile	176,265	170,000	192,799	−3.55%	+13.41%	+9.38%	105,919	106,250	105,050	+0.31%	-1.13%	−0.82%
Highest	5,027,381	2,901,796	5,274,667	−42.28%	+81.77%	+4.92%	3,255,621	4,107,000	4,107,000	+26.15%	0.00%	+26.15%
Average	377,953	363,552	400,572	−3.81%	+10.18%	+5.98%	248,103	239,510	230,052	−3.46%	-3.95%	−7.28%
Lowest	0	0	0	0.00%	0.00%	0.00%	0	0	0	0.00%	0.00%	0.00%

CEO	SMI			SMI Changes			SMIM			SMIM Changes		
	2007	2008	2009	07/08	08/09	07/09	2007	2008	2009	07/08	08/09	07/09
Upper Quartile	12,618,250	8,185,720	12,518,763	−35.13%	+52.93%	−0.79%	4,058,039	3,469,390	3,664,328	−14.51%	+5.62%	−9.70%
Median	7,727,944	5,351,799	5,861,461	−30.75%	+9.52%	−24.15%	2,750,174	2,520,853	2,178,500	−8.34%	−13.58%	−20.79%
Lower Quartile	4,792,787	3,770,484	3,935,927	−21.33%	+4.39%	−17.88%	1,788,900	1,581,127	1,383,553	−11.61%	−12.50%	−22.66%
Highest	22,280,000	20,544,032	20,471,929	−7.79%	−0.35%	−8.12%	12,024,884	7,062,808	7,840,619	−41.27%	+11.01%	−34.80%
Average	9,326,781	6,943,456	8,191,353	−25.55%	+17.97%	−12.17%	3,814,715	2,939,052	2,948,413	−22.95%	+0.32%	−22.71%
Lowest	1,704,000	1,814,702	1,819,000	+6.50%	+0.24%	+6.75%	1,012,836	930,824	710,000	−8.10%	−23.72%	−29.90%

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