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The Role of Shareholders in Executive Compensation: Theoretical underpinnings and practical analyses of the Swiss Referendum on the extent of shareholder involvement in executive compensation.

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ABSTRACT

Executive compensation is significantly increasing in countries where there is a low level of restriction or regulation on the subject matter. The debate as to whether the owners (shareholders) of the companies should get involved in the determination of compensation for executives is still inconclusive. Some researchers and practitioners are of the view that board members who have oversight responsibility over the corporate governance system must be left to determine the executive compensation and that the State should not interfere in the work of companies. Others however believe that the State has responsibility towards providing a conducive business environment for companies, including shareholders' rights and assets.

This working paper seeks to provide the descriptions about the specific provisions that were passed in the Swiss Referendum of a new resolution to put a cap on Executive Compensation for companies operating in Switzerland; a review of the pro's and con's of the action; the writer's own opinion about the proposal and the voting pattern in respect of the referendum (with particular emphasis on previous readings, research and best practices in executive compensation). The paper ends by discussing theoretical underpinnings and global best practices of executive compensation in similar jurisdictions and the world's corporate financial centres. The objective analysis of the Swiss March 2013 Referendum on Executive Compensation is based on several studies, global trends, theoretical underpinnings and best practices in executive compensation, and thus supports any regulations or provisions which allow compensation to be tied to performance of corporations.

Keywords : Executive Compensation, Shareholders, Referendum, Corporate Governance System

1 INTRODUCTION

For more than a decade, executive compensation in the European Union (EU), United Kingdom (UK), Switzerland, United States (US) and other jurisdictions has attracted severe criticisms and unfavourable interest from policy makers, governments, practitioners, academics, the media and the general public, for 'perceived' excessive compensation paid out, both in absolute terms and in comparison with other executives of the company. Executive compensation practices particularly came under intense scrutiny in the wake of the global financial crisis and economic recession. Most of the remarks were whether the quantum of compensation was consistent with shareholder interests (Jensen and Murphy, 2009), or whether the high executive rewards were hinged on performance metrics of corporations. This is particularly the case when companies are performing badly. Indeed people contend that if a company is inert or not performing as well as it did in the past, then executive compensation should remain the same or be adjusted downward accordingly. Over the last few years in Switzerland, the public accused some of Switzerland's biggest firms of keeping shareholders in the dark about executive compensation packages which had soared significantly over the past years (Stutz and Hösly 2012). The public clearly expected executive compensation to be reduced to a more moderate level in general and the bulk of variable compensation to be forfeited in case of unsatisfactory performance by a company.

Consequently, such contentious issues have come under constant regulation, with government directives, policies, laws and voluntary codes (e.g. Greenbury Report (1995), Combined Code (2003), etc) giving shareholders voting rights on companies' compensation practices. The approaches adopted by countries have become inconsistent in respect of executive compensation. Voting rights are either binding or non-binding (advisory), voluntary or involuntary, or a "two-strike" approach in some countries. These regulations had attempted to address these concerns by demanding that companies increase the proportion of compensation that is performance-related rather than fixed salary, and by increasing the level of disclosure of executive reward. In March

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2013, the people of Switzerland voted overwhelmingly in a referendum to completely regulate and review executive compensation for companies operating in Switzerland.

This working paper provides the descriptions about the specific provisions that passed in the new resolution; a review of the pro's and con's of the action; the writer's own opinion about the proposal and the voting pattern in respect of the referendum (with particular emphasis on previous readings, research and best practices in executive compensation). The paper ends by discussing theoretical underpinnings and global best practices of executive compensation in similar jurisdictions and the world's corporate financial centres.

2. MAIN PROVISIONS

On March 3 2013, citizens of Switzerland were asked to accept or reject the people's initiative regarding executive compensation in a referendum. An overwhelming 62.69% of the people and all the 26 Swiss cantons voted to amend Swiss federal legislation over an initiative regarding executive compensation in the following key provisions:

a) Require a binding annual vote by shareholders to set aggregate compensation for the board of directors; i.e. each year, shareholders of Swiss companies must have the right to vote on the aggregate amount of compensation paid to supervisory board members (the functional equivalent of a U.S. corporate board of directors), executive board members (members drawn from senior management) and advisory board members (Meridian Compensation Partners, 2013).

b) Require the articles of association to include bonus schemes and compensation plans for directors and executive officers; i.e. a Swiss company's articles of association (the functional equivalent of a U.S. corporation's articles of incorporation) must include rules on compensation plans from which compensation may be granted to directors and managers, incentive programs, the number of board positions directors and managers may hold outside the company and the duration of managers' employment contracts (Meridian Compensation Partners, 2013).

c) Ban advance and severance packages; Swiss companies are barred from making any compensationments to executives when they part ways with the companies or prior to start of financial year of the company, or from giving any substantial benefits to executives when the company is taken over by another firm.

d) Require board members and the chairmen to be individually elected by shareholders every year; each year, shareholders of Swiss companies must have the right to elect the chair of the supervisory board, each member of the supervisory board and of the supervisory board's compensation committee (Meridian Compensation Partners, 2013).

e) Ban corporate proxy and the representation of shareholders by depository banks. Shareholders of Swiss companies are barred from corporate casting votes for board members, and changing business procedures or salaries for executives or directors, and would not permit depository banks to represent shareholders in any interest (Minder, 2013).

f) Pension funds voting requirement. Swiss pension funds must vote in the interests of their members and must disclose how they voted with respect to annual say on compensation vote and director elections (Minder, 2013).

g) Monetary and criminal penalties. Noncompliance with any of the foregoing provisions may result in a fine of up to six years' annual compensation and imprisonment of up to three years. (Meridian Compensation Partners, 2013).

The "fat cat initiative", as it has been called, was written into the Swiss constitution and would apply to all Swiss companies listed on Switzerland's stock exchange.

3. PRO'S AND CON'S OF MAIN PROVISIONS

Whilst it is not for any Government to directly get itself involved in micromanaging how compensation or board remuneration is set, it does have a role to create the right governance framework for companies and to ensure that, shareholders have the right information and tools to hold companies to account. Several people in support (or with different opinions) of this referendum might have cited the following arguments:

3.1 Binding Annual Vote by Shareholders to set aggregate compensation for executives

Those in support of this provision argue that providing shareholders with a binding vote on executive compensation is in line with best practices and earlier studies on executive compensation (for example, Karpoff, Malatesta, and Walkling (1996) and Gillan and Starks (2000)) have reported that non-binding shareholder resolutions appear to have no consistent effects on corporate performance and shareholder values. This evidence suggests that advisory say on compensation is not likely to affect corporate compensation levels, though it may succeed in putting a spotlight on companies with governance failures. Additionally, the binding annual vote by shareholders will provide opportunity for shareholders and empower them to help align performance of its executives with compensation every other year. It will also provide support for more commitment and engagement between companies and shareholders, and create a strong link between incentives and performance. The Government of Switzerland has acknowledged with this provision that it is shareholders who have the power to control excessive executive compensation without link to performance. Empowering shareholders with stronger voting rights will enable them to promote a stronger, comprehensive link between compensation and performance and to restrict payments for mediocrity or failure, while still allowing for outstanding performance to be rewarded. Companies will be encouraged to be proactive in designing compensation policy which is acceptable to shareholders and to respond appropriately to shareholder challenge. In the Netherlands, for example, has a similar provision to the Swiss where shareholders have been permitted to a binding vote on major changes to remuneration policy since 2004, and have resulted in greater levels of engagement between companies and shareholders (Bebchuk and Fried, 2004). Moreover, there was a positive relationship between shareholder value and executive compensation from a research conducted by Groningen University in 2007 on behalf of the Dutch Corporate Governance Code Monitoring Committee (Impact Assessment, 2012).

Those with alternate views however believe that there is no prior assumption that the binding annual vote by shareholders in itself will directly reduce the overall quantum of directors' compensation, although a result of a stronger link between compensation and performance could be that average compensation levels fall or cease to rise as quickly as they have in the last decade. Additionally, opponents on a binding on "say-on-pay" believe that boards of corporations should continue to be empowered to exercise their discretionary powers to design their own compensation packages that are appropriate for the firm as a whole and that should be enough to produce the right incentive alignment (Frydman and Jenter, 2010). Again others believe that the binding vote on directors' compensation policy might put Switzerland at a competitive and comparative disadvantage in the international market for CEOs and Directors if companies are restricted in their ability to recruit and determine appropriate compensation levels. To mitigate this, companies will be able, as part of the vote on compensation policy, to seek shareholder approval for flexibility in the way they approach recruitment.

3.2 Articles of association to include bonus schemes and compensation plans for executives

The proposal which allows shareholders to require the articles of association to include bonus schemes and compensation plans for directors and executive officers is to ensure that first of all, exit payments would not reward failure. The bonus schemes and compensation plans may be so designed with 'recovery' provisions to enable deferred remuneration to be adjusted downwards where performance has not been continuous and to equip remuneration committees with the necessary mechanism to appropriately adjust the size and type of performers. This also helps to mitigate excessive risk-taking by directors as it makes it clear that remuneration can be adjusted downwards if performance takes a downward turn. Moreover, inclusion of incentives such as bonus schemes and compensation plans for executives is a reward for higher risk - in other words, the value of deferred compensation is discounted because of the possibility it will not be paid.

Nonetheless, many people generally feel that bonus schemes and incentives have become too complex and prescriptive, and are not aligned to the business strategy or within their control. As a result, they do not believe incentives drive performance or change behaviours and many perceive incentives simply to be a lottery. Moreover, the provision in the referendum did not take into consideration the complexity of bonus structures and the lack of transparency around boardroom compensation, which remain major part of the problem (Minder, 2013). If any progress on executive remuneration is made going forward, it is critical that boardrooms explain clearly how rewards (in terms of bonus) are linked to performance and how that impacts shareholder value.

3.3 Ban advance and severance packages

Executives and Directors typically accrue significant rewards over the course of their career, including sizeable pensions, and therefore it is in the right reasoning for the Swiss Government to ban any advance and severance (exit payments) that represent an extremely generous package in comparison to other employees' termination packages; in particular where their performance has been poor. It is unacceptable that poor performance by senior executives, which diminishes the value of a corporation and threatens the livelihood of employees, can result in excessive payments to departing directors.

Paying severance packages and 'golden parachutes' can be used as a type of antitakeover measure taken by a firm to discourage an unwanted takeover attempt. Moreover, the practice of paying large exit payments to departing directors has become embedded in corporate practice (Bell, and Reenan van J., 2011). Shareholders currently have limited leverage on this issue because they have no direct role in negotiating or agreeing directors' service contracts and other arrangements, and it is these documents which make provision for such payments to be made. Furthermore, the existing mandatory shareholder vote on compensation payments applies only to payments made over and above that which the director is contractually entitled to. It therefore excludes payment in lieu of notice made as part of the director's contract (or damages paid for breach of contract). As a result, companies have a great deal of latitude over what is paid out before triggering the need for shareholder approval. So it becomes unacceptable to ban a fundamental corporate governance practice.

3.4 Shareholders elect board members and the chairmen every year

Though the proposed (re)-election of board chairmen and board of directors by shareholders is not a common practice, this resolution based on a yearly appraisal of directors will help shareholders to flush out directors who are either incompetent or self-seeking. A forceful legislation for shareholders to elect board members and chairpersons is not in the best interest of the corporation since the vast experience of board members and chairpersons are required to ensure the performance and progress of the company.

3.5 Ban corporate proxy and the representation of shareholders by depository banks

The advocates of corporate proxy access and the representation of shareholders by depository banks argue that some modest competition in the electioneering process of director

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(s) is desirable, given large investors are more influential in the electioneering process of appointing directors that would ensure to the benefit of shareholders.

The proponents of the corporate proxy ban are of the view that it would grant certain kinds of shareholders the power of attorney (for example, union pension funds/depository banks) to influence decisions that may be contrary to shareholder value maximization, and that proxy access might deter some well-qualified and competent directors from serving on corporate boards.

4.0 THE WRITER'S OPINION

The writer's verdict on this controversial issue is rooted in theoretical underpinnings of various studies on executive compensation structure, best practices and current trends in corporate governance systems around the globe.

4.1 Studies on executive compensation

A number of studies seem to suggest that over the last decade, CEO and Directors' compensation in listed companies in many regimes around the globe has quadrupled, with little evidence that this is a result of improved performance or in any way connected to shareholder returns (Merchant, Van der Stede & Zheng, 2003; Gabaix & Landier, 2007; Gabaix, & Landier, 2011 and Hay Group, 2013). One of the most frequently cited reasons for high levels of compensation is the impact of the international market for CEOs and the need to compensation above average to attract the very best talents and also to mitigate against the flow of country executives to other countries. Though this may be a legitimate concern, it is evident that compensation policies which do not appropriately link compensation to company strategy and performance have an economic cost through reduced shareholder returns, weakened corporate governance and reduced confidence in the corporate sector. Another reason is that companies' remuneration reports have become increasingly complex and unclear and the existing advisory vote on directors' compensation does not sufficiently incentivise companies to act on shareholder interests (Quinn & Brown, 2013). This is coupled with the fact that shareholders (owners of the company) do not have proper mechanisms and adequate information to persuade and control the directors appointed to run the company on their behalf.

Additionally, there is an increasing state of executive compensation particularly because those current compensation systems have resulted in unprecedented and unjustifiable compensation awards, which have culminated in a widening gap between executives' compensation and that of employees generally. Executive compensation systems are also becoming increasingly complex and therefore less transparent, also resulting in perhaps most significantly, numerous examples of dysfunctional executive behaviour and cases of 'payment for failure'. Corruption and cronyism are amongst the factors for the 'fat cat' elite reported by the media and everybody on the street. Several papers, by both academics and practitioners, had earlier suggested how remuneration practices might be changed (Lee, 2002; Bebchuk and Fried, 2004). Thus, as Wilhelm (1993) had stated, "the best remuneration schemes should reward executives for making decisions in the best interests of shareholders". The literature on executive compensation mostly focuses on compensation as principal-agent problem issue, in which remuneration contracts are designed to align executives' and shareholders' interests, (Merchant et al., 2003; Werner and Ward, 2004).

After continuous public criticism of the governments for their lack of stewardship over the determination of executive compensation and the threat to further regulate the compensation of some institutional investors. For instance, Association of British Insurers (ABI) and National Association of Pension Funds (NAPF), has become more proactive in defining what constitutes acceptable executive compensation arrangements of the companies into which they invest. However, it is still prudent for Governments and indeed their responsibility to ensure sanity in the determination of executive compensation vis-a-vis the shareholder interests.

4.2 Theoretical Support

Several studies of executive compensation are consistent with the theoretical underpinning around executive compensation in modern companies. The call for legislation as a measure of intervention to executive compensation escalation by regulators and governments is a result of a well established market failure at the centre of the corporate governance system. Traditional agency theory proposes a fundamental relationship, where shareholders entrust management and control of the company to their agents (directors). This separation of ownership from control leads to information asymmetry (Impact Assessment, 2012) and allows a problem of divergence of interests between the agents and principals (shareholders). The challenge is how to overcome completely the main obstacle in executive compensation – the principal agent problem. This inherent problem cannot just be reconciled through monitoring and controls alone because of the exorbitant cost involved (Trevor, 2009). How then do shareholders ensure that executives act in their best interests? Plethora of research within the traditional principal-agent theory literature suggests that, directors' compensation is considered to be the most efficient and effective mechanism for helping to minimise agency costs in order to align the incentives of managers with the interests of shareholders (Manifest/MM&K., 2011). It follows that where shareholders do not maintain control over directors' compensation there is a strong theoretical likelihood that directors might align the strategic objectives of the company to their projects that reward them personally and which may not contribute to the long term value of the company (Impact Assessment, 2012). The Pricewaterhouse Coopers 2009 Annual Compensation report (Executive compensation Review, 2009), shows that executives-at-risk-compensation is at its highest level historically, whilst fixed elements of salary, such as base compensation and benefits, are remaining static or decreasing proportionately. This suggests that shareholder interests and involvement are being represented more capably than ever before. This is theory at least.

4.3 Best Practices and Global Trends

Trends in executive compensation and best practices phenomenon that the increase in executive compensation in corporations is driven by competition cannot be entirely accurate. Indeed the drivers of these increases primarily include outside consultant surveys and strong position of many companies to have their directors and senior executives in at least the top half, and consequently in the top quartile of compensation scales. There is only a "ratchet" concept going on. For example, an insight into executive compensation practices of the FTSE 100 reveals that companies are surprisingly conforming to the norms: compete for top talents based on two principal alignments – quantum of compensation and compensation structure (Trevor, 2009). Research evidence suggests that fear of the risks of noncompliance depresses many organisations from developing innovative executive compensation in line with corporate strategy and performance, instead of a discrimination along the one remaining alignment – the quantum. Given the high competition in this most transparent labour market, the result is to drive market levels upwards as companies do whatever is necessary to secure the best available talent (Trevor, 2009).

Consequently, established codes are being reinforced by regulation and legislations in various jurisdictions, giving shareholders voting rights on companies' compensation practices, commonly referred to as 'Say on Compensation' (SoP) votes. Requests on say-on-compensation are some of the most familiar kinds of regulations among countries attempting to throw more light intensely on executive compensation. Generally, the say-on-compensation rules allocate shareholders with some power to cast advisory votes on whether the shareholders approve of the executive compensation packages offered to company executives. Studies have shown that the say-on-compensation approach effectively align compensation with performance instead of reducing it (Quinn & Brown, 2013). Globally, there are three primary varieties of say-on-compensation voting activities–a non-binding shareholder vote, a binding shareholder vote, and Australia's ''two strike''rule. The table 1 below provides a snapshot of the list of countries and type of SoP votes in place.

Table 1: Snapshot of SoP Practices

Country	Is SoP legislation in place?	Vote Type
Australia	Yes	Non-binding
Belgium	Yes	Non-binding
Canada	No	Issuers may voluntarily adopt SoP independently with non-binding vote
France	No. Under consideration	
Germany	Yes	Non-binding
India	Yes	Binding
Italy	Yes	Binding for banks and insurers. Non-binding for other issuers
Japan	Yes	Binding
Netherlands	Yes	Binding
Sweden & Nordic	Yes	Binding
UK	Yes	Currently, votes are non-binding. Additional binding vote from October 2013
United States	Yes	Non-binding

Source: www.haygroup.com, Jan 2014.

France set out the best practices of remuneration policy for board of directors and other executives. Shareholders of French companies are currently entitled to vote on resolutions on equity-based incentives and severance compensationments. There is a new regulation limiting CEO compensation on state owned enterprises, allowing shareholders to express their opinions on executive compensation.

France is preparing legislation to increase shareholder power over remuneration and limit or ban enhanced pension deals and 'golden parachutes' – similar to the measures Swiss voters approved in a referendum in March 2013. In the Netherlands, the Dutch law requests for a binding shareholder vote, but the vote does not necessarily occur annually and the shareholder vote concerns compensation policies, not a retrospective compensation report.

Following the Dutch model, Sweden and the Nordics in 2006 and 2007, respectively, also enacted legislation requiring a binding shareholder vote on compensation policies. Shareholders are permitted to a binding vote on the remuneration policy, including the variable compensation opportunity and performance measures for executives, severance compensation, share-based remuneration plans, etc. As a result, disclosure on the remuneration policy, the evaluation process and the explanation of the outcomes are enhanced. Company auditors are also required to make a statement at the AGM about the actual compliance of the remuneration policy. Shareholders in these countries are entitled to a binding vote at the AGM similar to the one in Switzerland.

In the United Kingdom, publicly listed companies have been subject to non-binding votes on executive compensation since 2002. The U.K. became the only country to require a say-on-compensation vote in 2003. The vote expresses shareholders' feelings about a corporation's executive compensation, as well as indications about investors' perceptions about the company's performance and behaviour and, in some cases, the capability of the CEO. The Department for Business, Innovation and Skills (DBIS) further proposed changes to directors' remuneration reports and voting in 2012, to separate reporting and voting into two parts: Policy report which determines factors enshrined in compensation reports and binding vote on exit compensationments above a given threshold; and Implementation report, also setting out how the policy was implemented over the past financial year. The DBIS is now proposing to add a binding vote (similar to the Swiss legislation) on both remuneration policy (to be obtained at least every three years) and exit compensationments to the currently required annual nonbinding vote on how a company's compensation policy would have been implemented in the previous year to take effect in October 2013 (Bryan-Low, 2012).

In the United States, there exists no compulsory regulations or other legal restrictions on setting executive compensation, (compared to some countries in table 1above), except the tax-related provisions, such as the $1 million limit on the tax deductibility of compensation that is not 'performance-based' (Quinn and Brown, 2013). This probably explains why the U.S. executives are paid significantly more than their foreign counterparts, and receives a greater share of their compensation in the form of stock options, restricted shares, and performance-based bonuses (Fernandes, Ferreira, Matos, and Murphy, 2008). Since July 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act became the most comprehensive financial regulatory overhaul in the last 50 years (Hay Group, 2013). This Act is related to shareholders' right on compensation matters and includes the following areas: (1) Say on compensation — this was fully adopted in 2012 and comprises non-binding (advisory) votes for shareholders with respect to executive compensation information disclosed in proxy circulars. A failure to respond effectively to a high level of dissatisfaction may result in 'withhold' or 'against' votes regarding the re-election of members of the compensation committee. (2) Say on parachutes — also fully adopted in 2012, it comprises non-binding votes for executive compensation compensationments and other benefits triggered by a change-in-control. These provisions are different from that of the Switzerland in that, the Swiss referendum completely bans advance compensationments and other severance packages.

5.0 CONCLUSION

Best practice shows that there is no straight forward solution to addressing disproportionate executive compensation as a consequence of the principal-agent problem. However, the way forward is through more and not less constructive engagement between companies and shareholders over issues of governance and executive compensation. The point is, no one stakeholder involved can decide alone what is, and what is not, appropriate. Regardless of whether the shareholder vote is through legislation or establishing direct parameters for executive compensation, laws or policies providing for public disclosure and transparency of executive compensation practices, or whether it is binding or nonbinding, voluntary or involuntary, or a two-strike approach, there must be an avenue for companies to be able to effectively communicate to their shareholders the relationship between executives' compensation and the company's performance in order to win shareholder support. Indeed the policy objective of the Swiss referendum was to address failures in the governance of directors' compensation by equipping shareholders with the enhanced tools they need to challenge companies and to increase corporate accountability of executive compensation policies and practices at publicly held companies. Shareholder empowerment lies at the heart of global corporate governance framework and these reforms are consistent with that approach. They will enable shareholders to promote a stronger, clearer link between compensation and performance and to confront companies on rewards for mediocrity or failure, while still allowing for exceptional performance to be rewarded.

The writer's analysis, based on several studies, experience, theoretical underpinnings, best practices and current global trends supports all the policy options outlined in the Swiss March 2013 Referendum. First of all, the writer supports any policy that will empower shareholders to have a say on how much their agents (directors and executives) are being paid in relation to a return on their investments. Secondly, the writer favours a level playing field for disclosure that is the same for all direct and indirect forms of compensation for its executives. The writer supports any reform (s) that would ban any advance and severance payment especially in instances where there is corporate failure. The writer would not make any categorical stance on whether ban of corporate proxy access is desirable or not. Indeed, each company should be allowed the freedom to make decisions based on the company's interest to shareholder interests. Research suggests that shareholders should generally favour proxy access, unless relative factors suggest that the company is already sufficiently responsive to shareholder interests (Subramanian, Becker, and Bergstresser, 2012). Lastly, the writer is in agreement with any provision in a regulation that requires disclosure of meaningful information on the company's executive compensation practices and policies relating to risk management and corporate performance.

While this controversial debate on excessive executive compensation continues to linger on, the writer would want to be part of any advocacy for the legislation of the levels or structure of executive compensation. It should be worth noting that, legislation itself is not a needless interference of corporate practices and choices that should be left with companies themselves, but it is the means by which governments or countries play their legitimate roles in addressing regulatory failures in the corporate governance framework around directors' compensation by empowering shareholders. It is the responsibility of any government to provide the enabling environment for businesses to thrive. With particular reference to Switzerland, the policy initiative will make the business environment attractive to investment, since a significant number of shares in many of the country's largest companies are already held outside the country and investors would want to invest in companies they can have control over (Minder, 2013). In all cases, Government should work with companies and investors on non-regulatory measures to improve the quality and usefulness of company remuneration reports and to promote good practice, including simplification of compensation.

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