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1 The Study

We are delighted to present the ninth edition of our study "Executive Compensation & Corporate Governance". This study is one of the most detailed Swiss studies available on the level and structure of board and executive compensation for the years from 2007 to 2014. This report provides a comprehensive picture of executive compensation for SMI, SMIM, and small-cap companies in Switzerland today. We hope you find this breadth of perspective helpful.

Several important observations emerge from this study. First, we are witnessing an increased convergence of board pay within the three groups of companies. Second, share ownership is becoming significantly more important among executives. Third, equity-based pay makes up a growing proportion of total compensation packages, particularly in SMI and SMIM companies. Fourth, in the last three years, Swiss companies have changed variable compensation payments to be more in line with performance, size, and other characteristics of companies.

In light of the fact that compensation plans can be challenging for shareholders to understand, the importance of compensation reports (and Annual General Meeting materials) in explaining the mechanics underpinning these plans continues to increase. Given the many different say-on-pay systems that Swiss companies have adopted, there is not a single best practice as regards the disclosure of information. Instead, boards of directors, executive management as well as investors – in particular institutional investors such as pension funds – have the responsibility to consider what is the appropriate design and disclosure approach for compensation matters in the specific context of a given company. An ongoing dialogue between boards of directors, investors, and other stakeholders is essential for fostering the long-term positive development of companies.

All data used in this study is based on disclosed compensation and governance 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 will find "Executive Compensation & Corporate Governance: Insights 2015" to be an interesting read that supports you in answering key questions and provides ideas for addressing today's reward challenges. As always, we welcome your feedback and hope to have the opportunity to discuss these issues with you.

Dr. Robert W. Kuipers
Partner

Remo Schmid
Partner

The Swiss Market Index (SMI) comprises the 20 largest corporations in Switzerland. The SMIM (SMI Mid) comprises the 30 largest mid-cap companies in the Swiss equity market that are not included in the SMI. Our small-cap sample essentially comprises the 50 largest stocks that are neither in the SMI nor in the SMIM.

2 Executive Summary

This study, Executive Compensation & Corporate Governance: Insights 2015, examines the changes from 2007 to 2014 in total compensation for the board of directors and CEOs as well as some governance topics. The key findings are:

- In the eight years under consideration (from 2007 to 2014), median non-executive chairman pay has increased in both SMI and SMIM companies: by 12.4% from slightly below CHF 1 million to slightly above CHF 1.1 million in SMI companies and by a striking 80% from around CHF 380,000 to around CHF 690,000 in SMIM companies. One difference between the groups is, however, that SMI chairman pay has essentially remained constant or in fact declined slightly since 2009, while in SMIM firms it has fluctuated more and increased strongly (+27.2%) in the most recent year. In small-cap firms (essentially the next largest 50 companies), median chairman pay, now at around CHF 310,000, is 5.8% below the level of 2007; however, it has been increasing substantially since 2008.

- Pay of other members of boards of directors has been largely constant in the SMI firms, but has been increasing in SMIM companies and small-cap firms. In 2014, the median board member of an SMI company received around CHF 310,000 (+3.56% since 2007), the median board member of an SMIM company received around CHF 210,000 (+22.8% since 2007), and the median board member of a small-cap firm received around CHF 120,000 (+11.4% since 2007).

- There has been continuing convergence in board pay among the three groups of companies. In 2009, when there was generally the greatest divergence, the median chairman of an SMI company received around 2.4 times the pay of the chairman of an SMIM company and 5.7 times the pay of the chairman of a small-cap company. Since then, these ratios have almost monotonically declined and are now at 1.6 and 3.5, respectively. Similarly, the median board member of an SMI company received around twice the pay of the median board member of an SMIM company and 3.5 times the pay of the median board member of a small-cap company. Since then, these ratios have almost monotonically declined and are now at 1.5 and 2.5, respectively. One interpretation of these findings is that while the job of a board member at a very large company has always been very demanding, it is – relatively speaking – at medium and smaller public corporations where the greatest additional demands on the competences and efforts of boards members have more recently surfaced.

- Both median and average CEO total compensation of SMI companies are lower than in 2007, while both median and average salaries in SMIM companies are higher than in 2007. Median compensation in small-cap firms is above the 2007 levels, while the average is below 2007. Over the eight years under consideration, median CEO pay has decreased in SMI companies by 7.9% from CHF 8.1 million to CHF 7.5 million in SMI companies, though it increased last year by about 11.8%. Median CEO total compensation also increased in SMIM companies in the past year, by 6.2% to CHF 3.4 million, suggesting that the strong increase in 2013 (+33.8%) was not a one-time outlier. Median SMIM CEO compensation is now 19.4% above 2007 levels. Due to some increases in pay at the top end of the range, average CEO total compensation in SMIM firms increased substantially from 2013 to 2014, by 19.3% to CHF 4.3 million, which is 8.3% above the 2007 level. In the last few years, we have also observed increases across the whole small-cap sample, with the lower quartile of small-cap CEOs passing the CHF 1 million level for the first time this year. Median CEO compensation of small-cap CEOs amounted to CHF 1.4 million in 2014, 16.1% above the 2007 level.

- Our analysis also reveals interesting dynamics in pay composition. In SMI companies, over the years, base salary has rarely made up more than 30% of total pay, equity-based pay never less than 30% (and often close to or more than 40%). Indeed, the average percentage of equity-based compensation has been increasing steadily over the years, from 38% in 2007 to 45% in 2014; at the median, the trend is even more pronounced, from 33% to 49%. In SMIM companies, in most years, base salary has been a more important component of compensation than equity-based compensation, but there is a trend towards increased usage of equity-based pay. Consequently, in the last two years, equity-based pay (around 35% on average) was more important than base salary (around 30%). In small-cap companies, equity-based compensation is still at a low level. Equity-based compensation increased from 13.5% in 2013 to 17.8% in 2014, but this is still much less than the 44% due to base salary on average.

- We document that on the individual CEO level, pay composition and pay levels are (unsurprisingly, but importantly) closely related. Benchmarking exercises, which do not take account of differences in pay structure, are, therefore, likely to yield a noisy picture.

- We are witnessing an increase in the “wealth lever”, especially in the SMI and SMIM companies. More CEOs are holding equity, with the proportion of CEOs who do not hold any shares dropping sharply over the past eight years. Moreover, those who already hold equity hold large positions (and/or do not sell the shares even though share prices have increased). While in 2008, the median ratio of equity wealth to base salary was around 1.6 and 1 in SMI and SMIM companies, respectively, this ratio has increased to almost 7 and 4, respectively. In small-cap companies it has moderately increased to 3.

- The rising importance of equity-based incentives in compensation packages also brings with it an increased importance of communication with shareholders, either through the compensation report or through the materials drawn up in preparation for the Annual General Meeting (AGM). In this report we present several key questions that these materials should address. We argue that open dialogue, pro-active communication, and stakeholder engagement are essential for fostering the long-term positive development of companies.

- In a special technical section, we report on results showing that excessive variable compensation has decreased in 2013 and 2014 in those companies where variable pay had, in 2012, been too high relative to the size, performance, and other characteristics of the company. This effect may be due to the changed general climate regarding corporate governance or due to more specific policy changes, such as the new say-on-pay regulation.

3 Top Management Compensation: Main Results

In this section, we analyse and comment on the level and structure of compensation for chairmen of boards of directors, other board members and CEOs. Our focus is on SMI and SMIM companies (sections 3.1 to 3.5), but we also provide a summary perspective on small-cap companies (section 3.6). This section mainly serves to describe some key facts in the data. Section 4 then provides commentary and draws conclusions regarding some particularly noticeable developments.

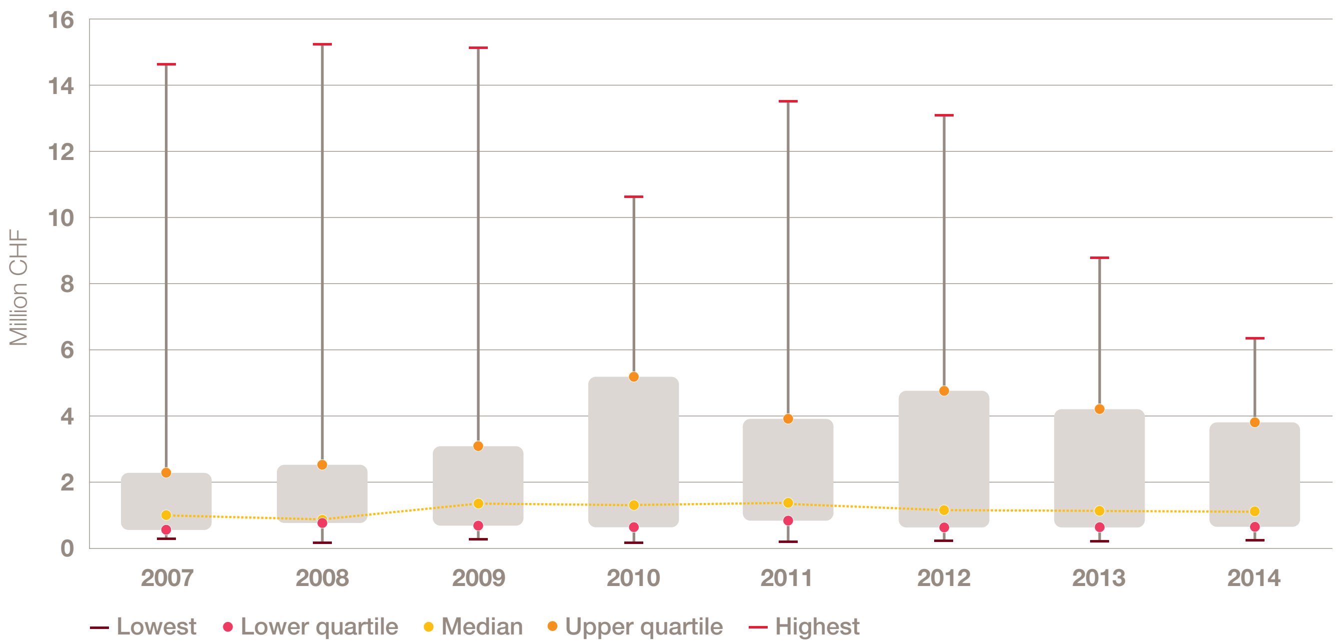
3.1 Chairmen of boards of directors

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. Some companies separately disclose pay that a chairman/CEO receives in his two roles. In this case, we include the corresponding individual with the chairman pay in this section and with the CEO pay in the CEO-related analysis. When pay is not shown separately for the two roles, this individual is considered only in the CEO analysis. We also do not include chairmen who held a non-CEO executive role in this analysis, unless pay for the executive function is separately disclosed.

3.1.1 Main findings

In the eight years under consideration, median chairman pay has increased in both SMI and SMIM companies, from CHF 981,479 to CHF 1.1 million, or by 12.4% in SMI companies and from CHF 384,327 to CHF 691,798, or by 80% in SMIM companies. Last year, median chairman pay in SMIM companies increased by 27.2%.

Figure 1: Total compensation of chairmen in SMI companies[1)]



1) Compensation for non-executive function (n=19 in 2014)

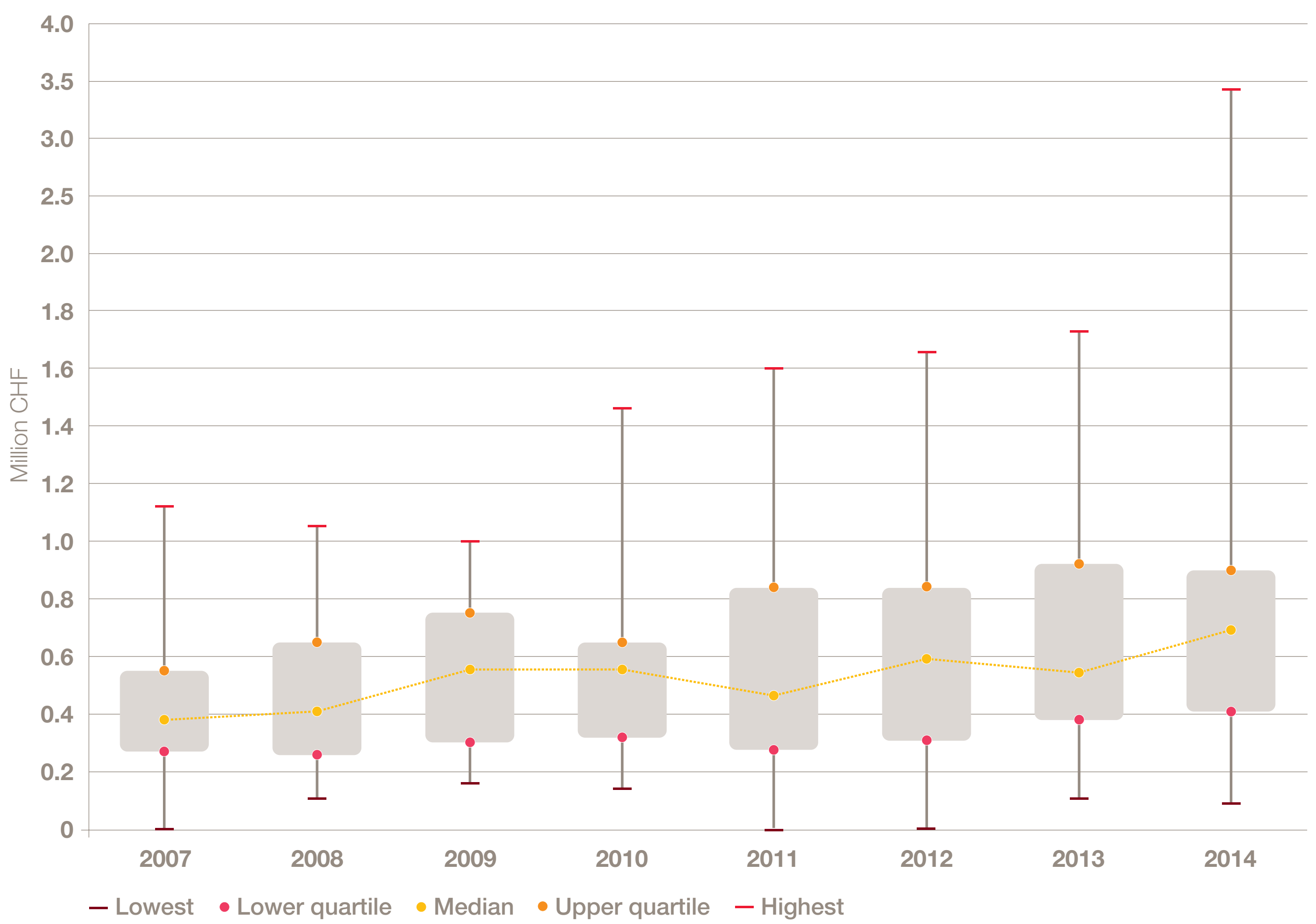
3.1.2 Details on SMI companies

From 2013 to 2014, the median SMI chairman compensation again remained largely constant at CHF 1.1 million. The upper quartile decreased by 9.5% to CHF 3.8 million, whereas the lower quartile increased slightly by 2.2% to CHF 634,076. Dispersion continued to decrease at the extremes: from 2013 to 2014, the compensation of the highest paid chairman decreased by 27.9% to CHF 6.3 million whereas the compensation of the lowest paid chairman increased by 15.5% to CHF 231,378.

3.1.3 Details on SMIM companies

For SMIM chairmen, the lower quartile increased by 7.9% to CHF 409,000 comparing 2014 with 2013. By contrast, the upper quartile decreased slightly by 2.4% to CHF 898,600. The highest paid SMIM chairman received CHF 3.4 million. Other parts of the distribution also shifted such that, in fact, the median also increased substantially by 27.2% to CHF 692,798 last year, 80% above the 2007 level.

Figure 2: Total compensation of chairmen in SMIM companies[2)]



[2)] Compensation for non-executive function (n=21 in 2014)

3.2 Other members of the board of directors

3.2.1 Main findings

In 2014, the median board member of an SMI company received around CHF 307,000, approximately 50% more than the median board member of an SMIM company who received around CHF 208,000. Compensation levels of SMI board members have been increasing slightly in a relatively small band for the years 2007 to 2014. For SMIM members, the increase has been more pronounced. We discuss patterns of convergence in more detail in Section 4.1.

3.2.2 Details on SMI companies

The lower quartile amounted to CHF 232,364 and the upper quartile to CHF 384,495 with small changes compared to last year, namely, an increase of 1.6% and a decrease of 4.1%, respectively. The median amounted to CHF 307,620 (a decrease of 3.4% from last year). The highest paid amount has varied a lot over the years. In 2014, it remained similar to last year, with a small decrease in this amount by 7.6% to CHF 2.5 million. The median increased slightly from CHF 297,059 in 2007 to CHF 307,620 in 2014 (+3.6%), though it had reached somewhat higher levels in interim years.

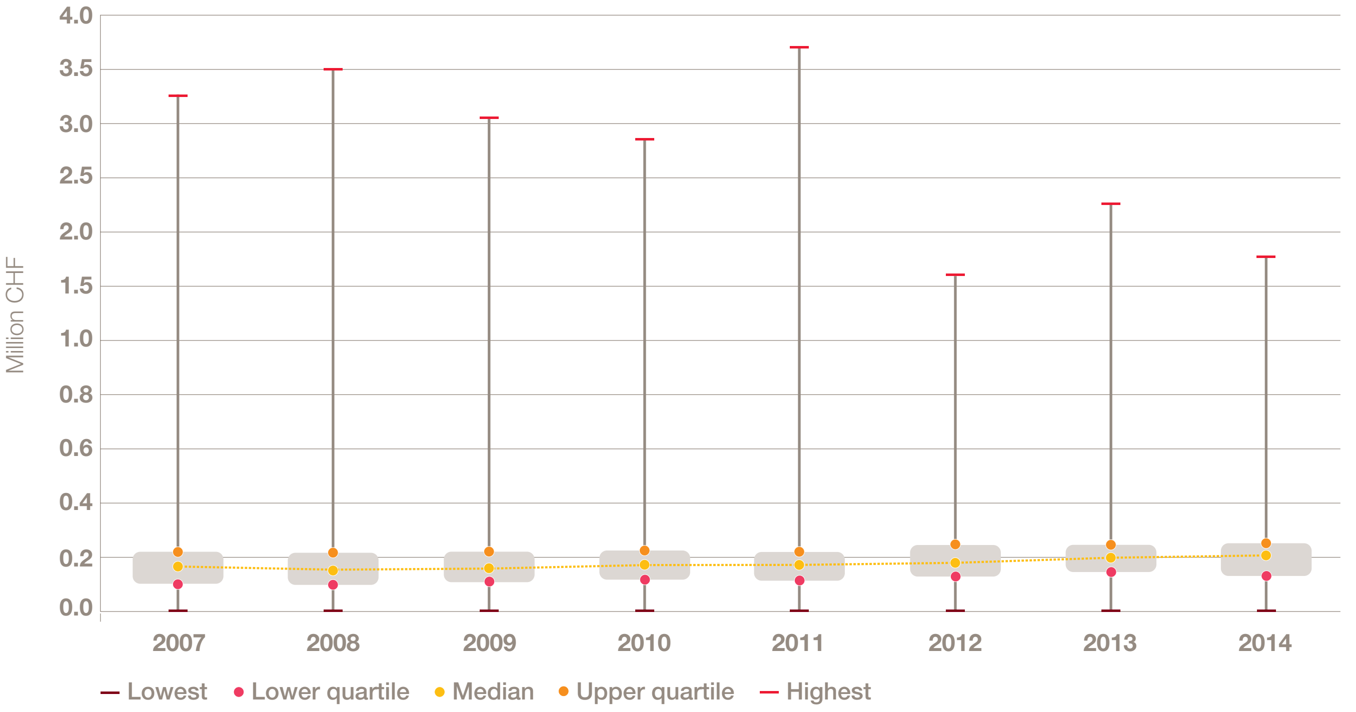
Figure 3: Total compensation of other members of the board of directors in SMI companies[3)]

[3)] Chairman and executive functions excluded (n=172 in 2014)

3.2.3 Details on SMIM companies

The lower quartile amounted to CHF 130,346 (–10.1% relative to 2013) and the upper quartile to CHF 254,250 (+2.4%), i.e., half of the SMIM board members were paid in this range for the year 2014. The median increased from CHF 169,500 in 2007 to CHF 208,120 in 2014 (+22.8%), with a fairly monotonic increase over the years. Median SMIM board pay is thus now roughly a third below median SMI board pay.

Figure 4: Total compensation of other members of the board of directors in SMIM companies[4)]



4) Chairman and executive functions excluded (n=182 in 2014)

3.3 CEOs

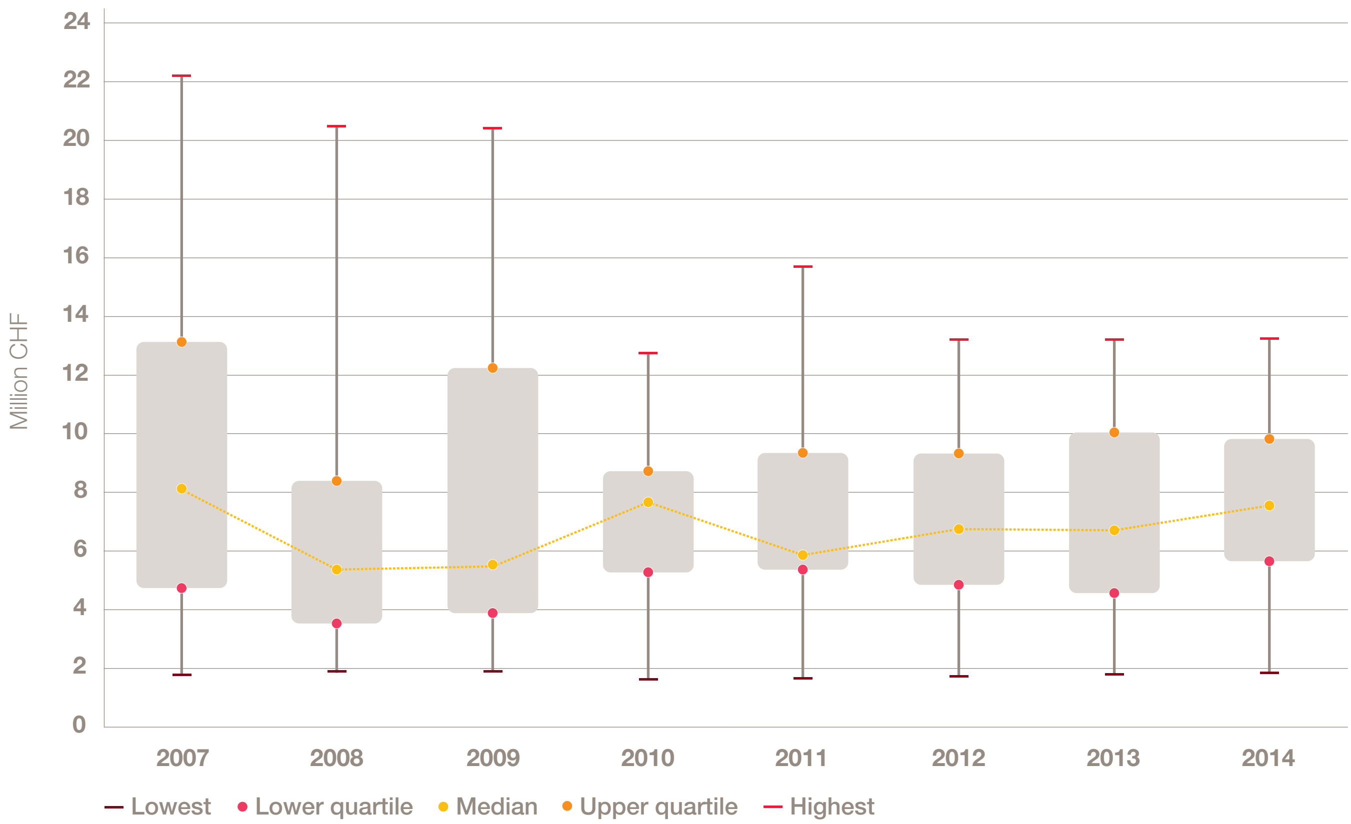
3.3.1 Main findings

From 2013 to 2014, total CEO compensation in SMI and SMIM companies moved in parallel again, as had previously been observed in the years 2007 to 2012. The year 2013, which showed a marked difference between SMI and SMIM companies, thus remains an outlier so far. Specifically, comparing 2014 to 2013, the median compensation of SMI CEOs increased by 11.8% from CHF 6.7 million to CHF 7.5 million. From 2013 to 2014, median SMIM CEO pay increased by 6.2% from CHF 3.2 million to CHF 3.4 million. Over the full sample period from 2007 to 2014, median CEO total compensation in SMI companies fell from CHF 8.1 million to CHF 7.5 million, or by 7.9%. By contrast, over the whole period median CEO total compensation in SMIM companies in fact increased from CHF 2.8 million in 2007 to CHF 3.4 million in 2014 (+19.4%).

3.3.2 Details on SMI companies

Comparing 2014 to 2013, the median compensation of SMI CEOs increased by 11.8% from CHF 6.7 million to CHF 7.5 million. The lower quartile increased even more, by 24.3% to CHF 5.6 million, whereas the upper quartile decreased slightly to CHF 9.8 million (–2.2%). The average total compensation increased by 5.8% to CHF 7.6 million, close to the median. As such, the average total compensation is still significantly below the figures for 2007 (CHF 9.5 million, –20.2%) when this study was conducted for the first time (see also Figure 9).

Figure 5: Total compensation of CEOs in SMI companies[5)]



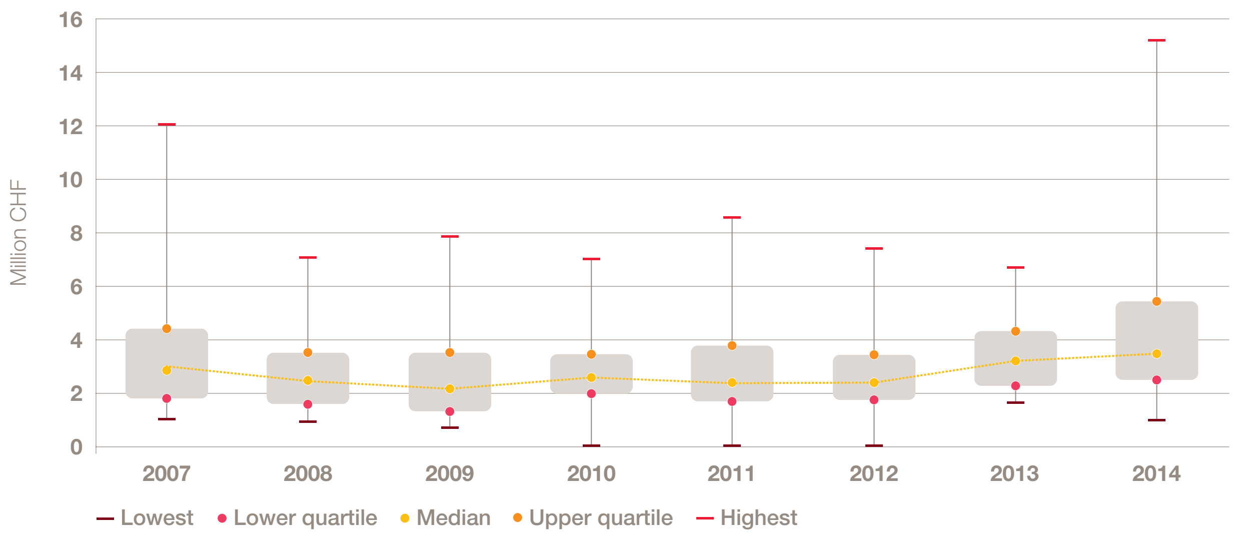
5) (n=20 in 2014) In 2014, there was only one (in 2013: one) company in which a member of the executive board other than the CEO received the highest total compensation. In 2008 and 2010, the highest paid disclosed person in the whole sample was not a CEO. In these firms the compensation of the CEO was not disclosed and so could not be used in Figure 5. Departing CEOs are not included in this calculation. Co-CEOs are averaged and treated as one observation.

3.3.3 Details on SMIM companies

Median total CEO compensation also increased in SMIM companies in the past year, but by less than compensation in SMI companies: it increased by 6.2% to CHF 3.4 million. Essentially, the whole distribution of CEO pay shifted upwards, but got more dispersed. The lower quartile increased by 6.1% and now amounts to CHF 2.4 million. The upper quartile increased by another 25% to CHF 5.4 million (after an increase by 26% in 2013). Consequently, 50% of SMIM CEOs are paid in a range between CHF 2.4 million and CHF 5.4 million. The lowest amount in 2014 (CHF 888,000) is roughly half the lowest amount in 2013, while the highest amount in 2014 (CHF 15.3 million) is more than double the highest amount in 2013.

Average total CEO compensation in SMIM companies also increased substantially from 2013 to 2014, by 19.3% to CHF 4.3 million. This follows on the back of an increase by 24.9% in 2013. Thus, from an overall perspective, the average total compensation has now surpassed the 2007 level by 8.3%, having gone from CHF 3.9 million in 2007 to CHF 4.3 million in 2014 (see also Figure 10).

Figure 6: Total compensation of CEOs in SMIM companies[6)]



6) CEOs (exclusive highest paids). n = 25 in 2014. Co-CEOs are averaged and treated as one observation.

3.4 Structure of compensation

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

3.4.1 Comparing roles: fixed versus variable pay

By and large, a similar picture emerges for SMI and SMIM companies when comparing the structure of compensation of different roles in terms of fixed versus variable pay.

Fixed compensation in Figures 7 and 8 refers to the sum of compensation in cash and non-performance-related payments conveyed in the form of equity-based compensation. On average, the largest part of the total compensation for chairmen and other board members – between 90% and 100% – comes from fixed and other compensation. By contrast, for CEOs and other executives, only between 35% and 50% of total compensation derives from fixed and other compensation. Instead, variable pay (either cash bonuses or equity-based long-term incentive plans) make up the biggest portion – between 50% and 65% – of the total compensation package for CEOs and other executives.

Figure 7: Overview of compensation structure in SMI companies in 2014

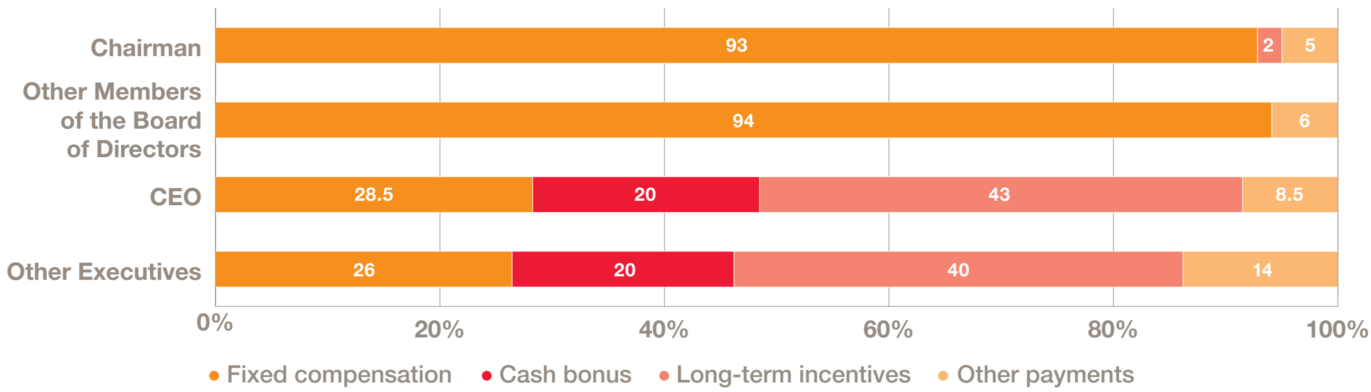
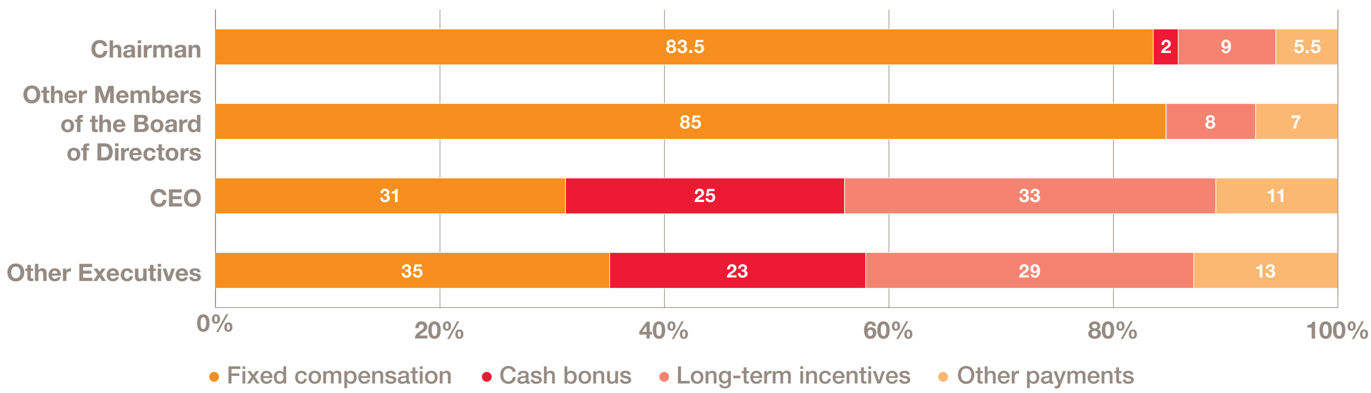


Figure 8: Overview of compensation structure in SMIM companies in 2014



3.4.2 *Trends in executive pay structure: cash versus equity-based pay*

This section analyses the development of CEO pay composition over time. It combines all types of equity-based pay (whether fixed or variable) into one category. (This provides a slightly different perspective than that shown in Figures 7 and 8.)

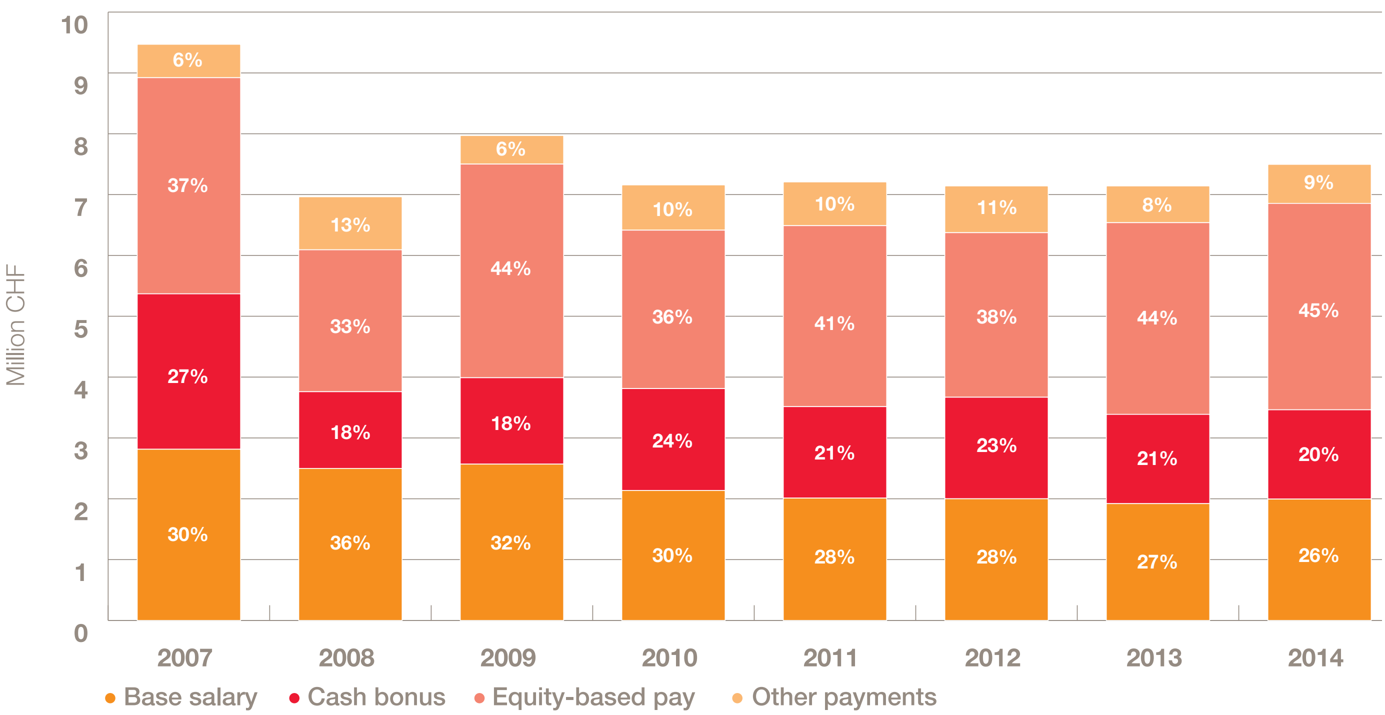
Figures 9 and 10 show, for each year, the average percentage that each compensation component makes up in total compensation of each CEO.[7]

For CEOs in SMI companies in 2014, the average total compensation was split into 26.4% base salary, 20.2% cash bonus, 44.9% equity-based pay, and 8.5% other compensation. Importantly, from Figure 9, it becomes clear that the percentage of equity-based pay has been increasing strongly over the years. In SMI companies, base salary has rarely made up more than 30% of total pay and is now at its lowest percentage level ever.

In SMIM companies, too, we observe changing composition dynamics. For 2014, the average total CEO compensation in these companies was split into 28.9% base salary, 24.9% cash bonus, 35.3% equity-based pay, and 10.9% other compensation. In Figure 10, we can see that in SMIM companies, too, base salary is now at its lowest percentage level ever. Equity-based pay has overtaken base salary in importance in the past two years. While equity-based pay was below 30% in most years, it was significantly above 30% in 2013 and 2014.

Overall, some changes appear to be taking place especially in the structure of CEO pay, and we will carefully monitor these developments. In Section 4, we provide additional analysis of the implications of these changes.

Figure 9: Structure of average total compensation of CEOs in SMI companies



[7] Note that these figures can only be interpreted with respect to the percentages shown, that is, with respect to the structure of compensation. They should not be interpreted as showing the average CHF amounts of compensation of each component. This is because not only the structure, but also the level of compensation differs across the sample. We discuss in Section 3.4.3 how the actual average CHF amounts of each component have changed.

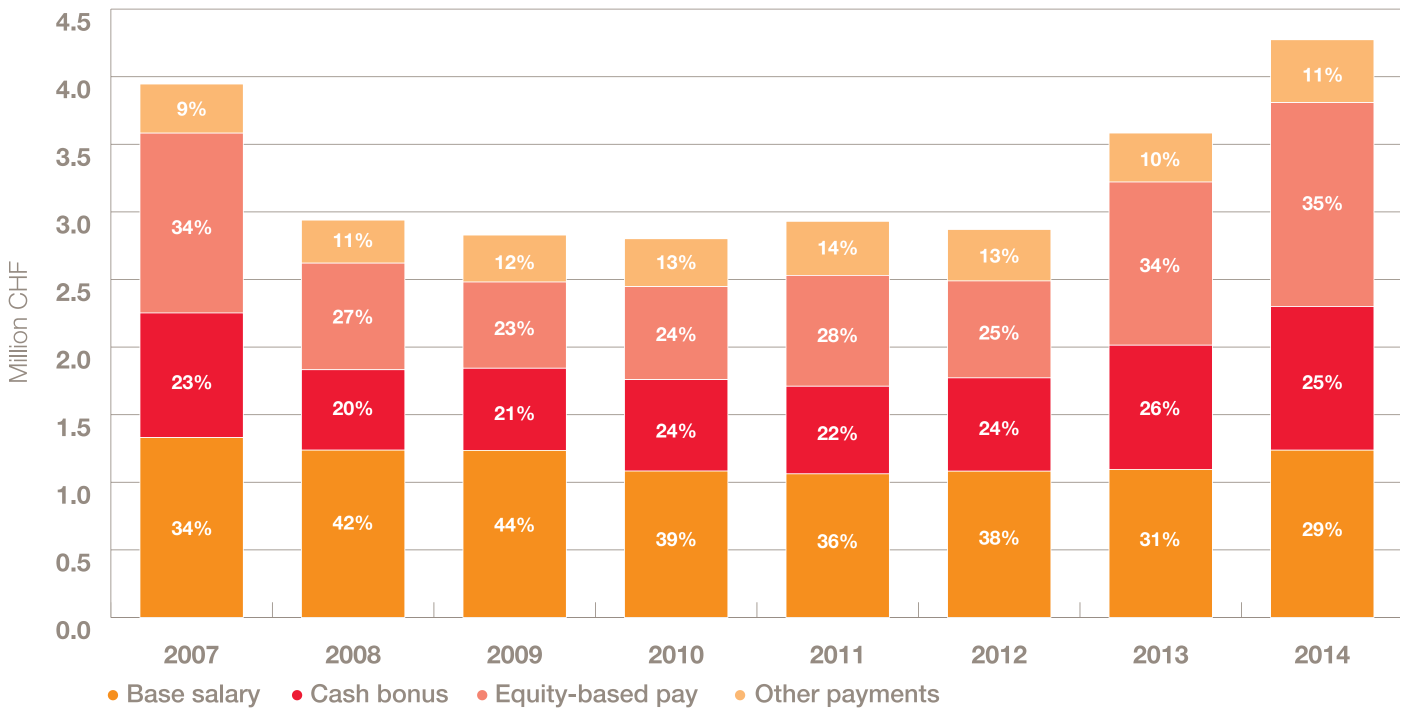
3.4.3 Changes in the amounts of various compensation components

This section discusses how the average CHF amounts of compensation of each component of compensation have changed over time. As explained in Section 3.4.2, these amounts cannot be directly compared to the coloured elements in Figures 9 and 10.

In 2014, for SMI companies, the average base salary amounted to CHF 1.8 million, increasing by 8.3% from CHF 1.7 million in 2013 (but decreasing from CHF 2.2 million in 2007, which corresponds to a decrease of 15.6%). The average cash bonus amounted to CHF 1.4 million in 2014, which is an increase of 6% compared to 2013 (and a decrease of 34% from 2007). Total average cash compensation (base salary and cash bonus) increased by 8.7% to CHF 3.4 million comparing 2014 to 2013. Average long-term incentives increased from CHF 3.4 million in 2013 to CHF 3.5 million in 2014 which represents an increase of 3.4%. (Although this represents a decrease of the CHF amount of long-term incentives by 25% from 2007, the percentage of equity-based pay went up from 2007 to 2014 because average total compensation came down.)

For SMIM companies, the average base salary decreased by 3.8% from 2013 to 2014 to CHF 959,751 and is substantially below the level of 2007 (CHF 1.1 million). The average cash bonus increased from CHF 935,730 in 2013 to CHF 1 million in 2014, which equals +7.6%. Strikingly, the average long-term incentives increased from CHF 1.1 million in 2013 to CHF 1.7 million in 2014 (+46.1%). Combining these developments and putting them into relation to the total pay packages, the long-term incentive portion increased in 2014, while the portion of base salary as well as the cash bonus decreased.

Figure 10: Structure of average total compensation of CEOs in SMIM companies



3.5 Wealth changes due to share ownership

In addition to analysing the total compensation development, 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 the case of volatile markets. Table 1 lists these changes and developments. The highest gains and losses relate to chairmen and other board members who have significant share holdings (in particular as founders or founding family members).

Table 1: CEO and board of director wealth changes in SMI and SMIM companies in the years 2008 to 2014 due to ownership[8)]

2008	Highest gain	Top 25 % (upper quartile)	Median	Bottom 25 % (lower quartile)	Greatest loss
CEOs	+42,800,000	–230,000	–730,000	–2,880,000	–2,750,000,000
Chairmen	+190,000	–290,000	–1,820,000	–18,700,000	–466,000,000
Other Members of the Board of Directors	+42,800,000	–40,000	–200,000	–200,000	–3,010,000,000
2009	**Highest gain**	**Top 25 % (upper quartile)**	**Median**	**Bottom 25 % (lower quartile)**	**Greatest loss**
CEOs	+10,300,000	+860,000	+340,000	+20,000	–35,400,000
Chairmen	+2,170,000,000	+5,810,000	+240,000	+10,000	–30,100,000
Other Members of the Board of Directors	+1,440,000,000	+230,000	+50,000	+/–0	–23,000,000
2010	**Highest gain**	**Top 25 % (upper quartile)**	**Median**	**Bottom 25 % (lower quartile)**	**Greatest loss**
CEOs	+20,000,000	+790,000	+170,000	–80,000	–21,100,000
Chairmen	+1,899,000,000	+650,000	+90,000	–80,000	–32,100,000
Other Members of the Board of Directors	+713,000,000	+120,000	+10,000	–30,000	–587,000,000
2011	**Highest gain**	**Top 25 % (upper quartile)**	**Median**	**Bottom 25 % (lower quartile)**	**Greatest loss**
CEOs	+10,600,000	–100,000	–400,000	–1,060,000	–99,300,000
Chairmen	+10,600,000	–110,000	–360,000	–1,290,000	–70,800,000
Other Members of the Board of Directors	+44,400,000	–10,000	–70,000	–270,000	–1,570,000,000

8) 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 shareholdings 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 to 2014 the same methodology is applied. All shares (not only vested shares) are considered. Companies that report no shareholdings for the respective category of individuals are not considered in this table. Significant changes in wealth in these calculations can also arise, independent from developments in the share price, when an individual acquires or sells shares. Outside (non-equity) wealth is not observable. 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 shares.

In 2008, at least 75% of CEOs, chairmen and other board members suffered net wealth losses resulting from falling share prices. In 2009, we observed the mirror image, i.e., at least 75% of the managers benefited from rising share prices. In 2010, an intermediate result occurred. The median CHF wealth change due to ownership was around zero or slightly positive for all three groups. The difficult market environment in 2011 led to broad losses throughout, and so the gains the median CEO, chairman and board members had made in 2009 and 2010 essentially evaporated in 2011. In 2012 the significant positive market development helped the median CEO recoup all losses from the previous year so that the overall wealth position of this (imaginary) median CEO was, at the end of 2012, approximately the same as at the beginning of 2008. The year 2013 then resulted in significant positive wealth changes.

In line with the general stock market development, the year 2014 brought continued positive wealth changes for many board members and executives, though there was more heterogeneity than in the prior year and the median increases were smaller than in 2013. For example, the median CEO's wealth in equity in his company increased by CHF +150,000. The wealth changes of the middle half of CEOs, chairmen, and other board members are in a relatively narrow range around the median, but the bottom quartile lost equity wealth in the previous year. 50% of all CEOs (between the lower and upper quartile) experienced wealth changes in the amount of CHF –390,000 to CHF +1,860,000. For chairmen, this range is from CHF –90,000 to CHF +760,000 for 2014. For other board members, this range amounts to CHF –10,000 to CHF +130,000 for 2014.

In addition to these absolute numbers, it is interesting to put the ownership of management members into perspective with their regular income, in particular the base salary. Section 4.3 below highlights striking trends in ownership.

2012	Highest gain	Top 25 % (upper quartile)	Median	Bottom 25 % (lower quartile)	Greatest loss
CEOs	+59,300,000	+1,350,000	+580,000	+150,000	–10,200,000
Chairmen	+519,000,000	+590,000	+140,000	+30,000	–760,000
Other Members of the Board of Directors	+1,100,000,000	+240,000	+60,000	+10,000	–175,000,000

2013	Highest gain	Top 25 % (upper quartile)	Median	Bottom 25 % (lower quartile)	Greatest loss
CEOs	+168,000,000	+2,150,000	+1,250,000	+540,000	–1,730,000
Chairmen	+71,400,000	+1,450,000	+570,000	+180,000	–310,000
Other Members of the Board of Directors	+455,000,000	+400,000	+100,000	+30,000	–61,900,000

2014	Highest gain	Top 25 % (upper quartile)	Median	Bottom 25 % (lower quartile)	Greatest loss
CEOs	+211,000,000	+1,860,000	+150,000	–390,000	–8,620,000
Chairmen	+175,000,000	+760,000	+80,000	–90,000	–4,880,000
Other Members of the Board of Directors	+1,170,000,000	+130,000	+20,000	–10,000	–79,100,000

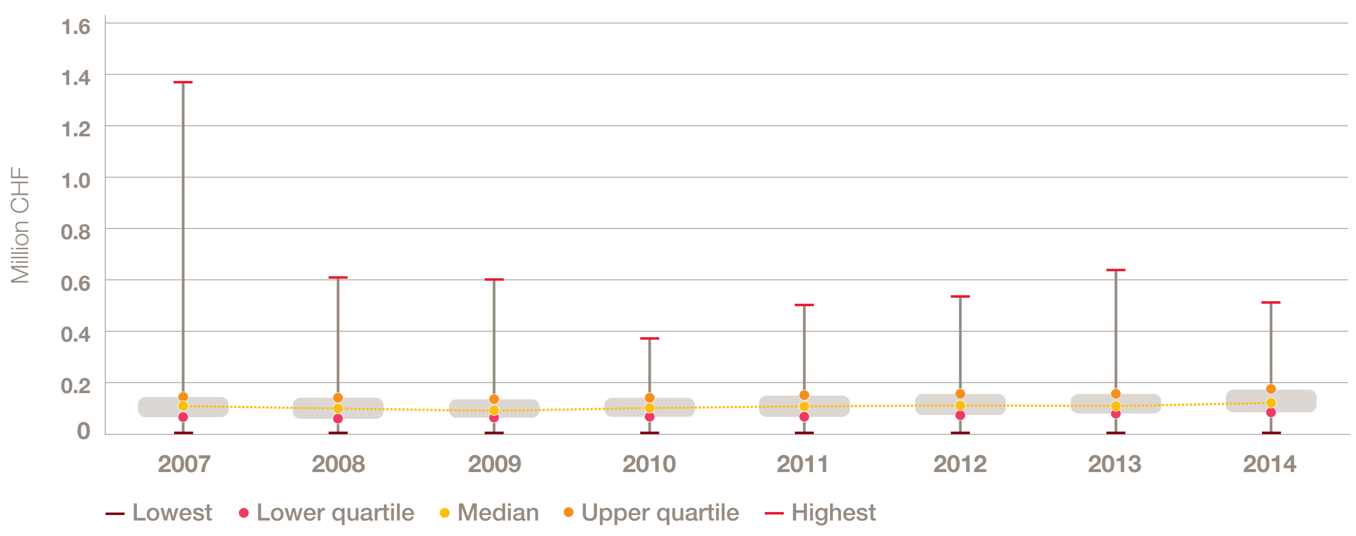
3.6 Small-cap companies

As in previous years, we have also examined compensation of executives and board members in a wider sample. In particular, we also consider those companies that ranked 51st to 100th in terms of equity market capitalisation at the end of the year. Essentially, our study covers those 50 companies in the SPI Large and SPI Mid indices (which together contain 100 companies) that are not in the SMI and the SMIM. We refer to these companies in total as small-cap companies.

Naturally, this large sample provides a wealth of data. We highlight some salient, general facts here. More detailed evaluations, geared to the interests of the reader, are available on request.

The median board member at a small cap company receives pay of around CHF 120,000. This pay level remained essentially stable from 2007 to 2013, but increased by about 11.5% last year. The median CEO of a small-cap company received CHF 1.4 million in 2014. As such, median CEO pay has increased by 11% from 2013 to 2014, putting it 16.1% above 2007 levels. While total compensation of small-cap CEOs generally tends to be less volatile over time than pay of SMI and SMIM CEOs, the year 2014 brought pay increases across the whole small-cap sample, with the lower quartile of small-cap CEOs passing the CHF 1 million level for the first time. The range of the middle 50% of small-cap total CEO compensation is now between around CHF 1.1 million (+16.5%) and CHF 2.1 million (+10.7%). This corresponds approximately to the range of the middle 50% of base salaries for SMI CEOs.

Figure 11: Total compensation of other members of the board of directors in small-cap companies[9)]



[9)] n = 297 in 2014

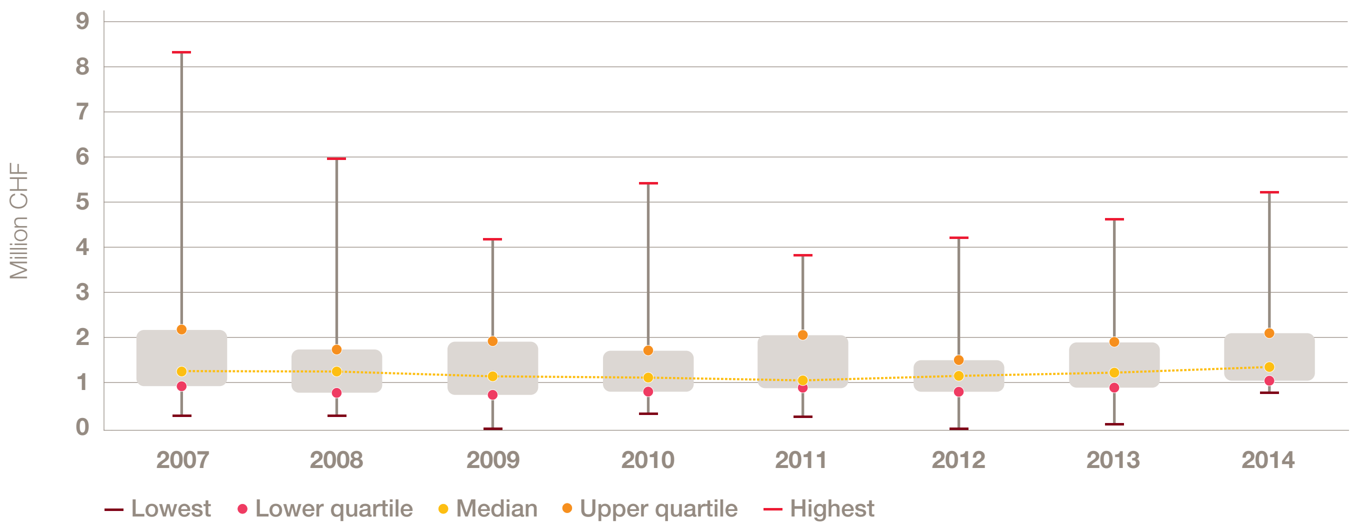
Rewards in the form of equity participation are of relatively minor importance for CEOs in small-cap firms. The average fraction of incentives paid in the form of equity increased from 13.5% in 2013 to 17.8% in 2014. However, the portion of base salary in total compensation still makes up around 44% in 2014, and this percentage has not changed much recently.

Finally, we have also analysed the wealth changes due to share ownership of executives and board members in small-cap firms. Table 2 presents the results of this investigation of equity wealth changes. It is more difficult than in the case of the SMI and SMIM companies to compare amounts across years because the sample composition changes more for the small-cap firms. Nonetheless, by and large the table shows that, over the years, the median small-cap executives and board members have experienced much the same fluctuations as their colleagues in the larger firms.

Table 2: Median CEO and board of director wealth changes in small-cap companies in the years 2008 to 2014 due to ownership[10]

	CEOs	Chairmen	Other members of board of directors
2008	–360,000	–220,000	–40,000
2009	+90,000	+70,000	+10,000
2010	+70,000	+90,000	+15,000
2011	–180,000	–80,000	–20,000
2012	+90,000	+40,000	+10,000
2013	+160,000	+150,000	+16,000
2014	+20,000	+5,000	+/–0

Figure 12: Total compensation of CEOs in small-cap companies[11]



[10] For details on the calculation, see footnote 8.

[11] n = 46 in 2014. In 2013, one company, which belonged to the SPI Large index but was not part of SMI nor the SMIM indices is not included in this study as we consider it not to be representative for the sample we wish to study.

4 Executive Compensation and Corporate Governance: Challenges and Opportunities

After having laid out the landscape of top management pay in Switzerland in the previous section, we now proceed to further analyse some salient features of this landscape, how it has been changing over the years, and what this implies for companies. In Section 4.1, we drill deeper in our analysis of the results presented earlier regarding board pay. Specifically, we look at the relative compensation of board members in the three groups of companies. Section 4.2 turns to executives, reviews trends in the usage of equity-based compensation and relates these trends to developments in compensation levels. Section 4.3 continues the investigation of the role of direct alignment of executives with their companies by documenting striking trends in share ownership. For each of these sections, in addition to discussing the substantive results, we add some implications for practice. Section 4.4 discusses how boards of directors and company management should prepare for next year, including the upcoming proxy season. Finally, in a more technical analysis, in Section 4.5 we address the question of whether companies with previously "excessive" variable compensation payments have adjusted their compensation levels in recent years.

4.1 What is the relative development of board pay?

The demands on members of boards of directors have arguably substantially increased over the past few years. Our analysis in Sections 3.1, 3.2 and 3.6 revealed a general upward trend, with some fluctuations, of board pay, within each of the three groups, SMI, SMIM, and small-cap companies. In this section, we ask an additional question: How does board pay relate across the three groups? Shedding light on this question is important because it reveals to companies what the market considers as the appropriate relative pay level to attract competent board members from other companies.[12]

Figure 13 reveals a striking picture. Panel A shows that in 2007, the median chairman of an SMI company received around 2.6 times the pay of the median chairman of an SMIM company. Since then, this ratio has declined (with a brief outlier in 2011) to about 1.6 in 2014. At the same time, Panel B documents that while the median SMIM chairman was paid approximately the same as the median small-cap chairman in 2007, in 2014, median SMIM chairman pay was more than double that of a small-cap chairman. In other words, SMIM chairmen have been catching up on the largest companies and have left the smallest companies behind.

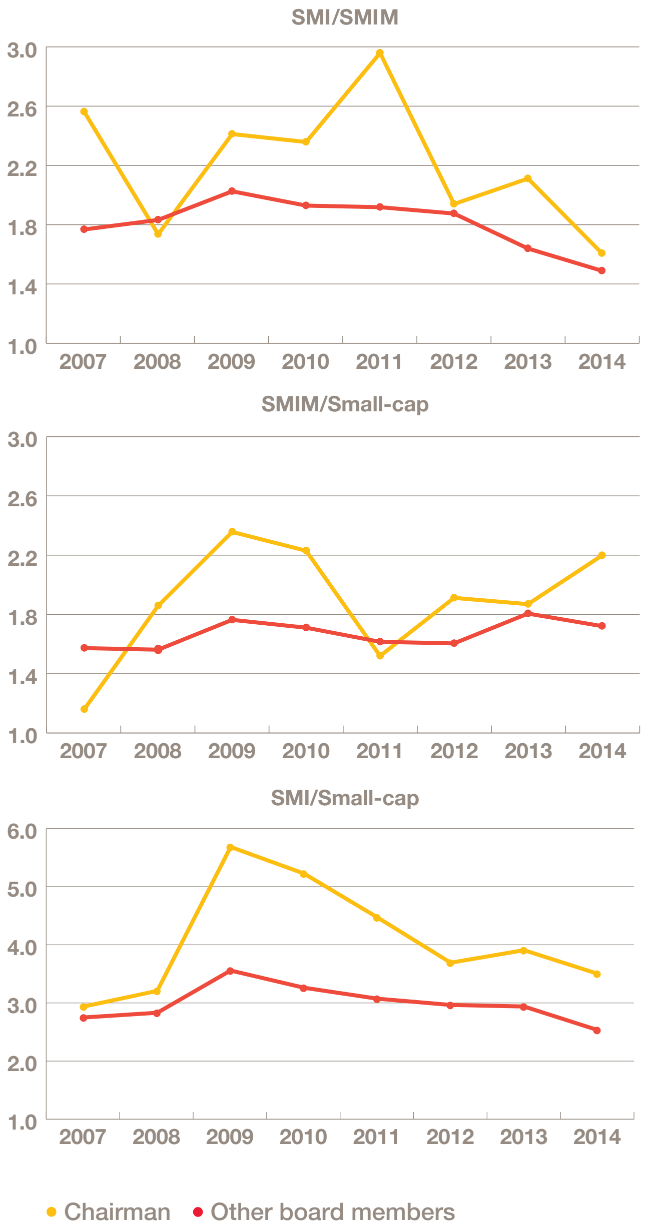
A similar picture, though not quite as strong, also emerges when considering other members of the board of directors.

Panel C completes the picture by considering the ratio of SMI chairman pay and small-cap chairman pay. These are, of course, enormously different companies. There are two ways of looking at these data. One is to note that comparing the very beginning (2007) and the end of the sample period (2014), the ratios are approximately similar, but with a slight divergence: they go from 3 to 3.5 for chairmen and from 2.75 to 2.5 for other members of the board, respectively. Alternatively, it may be reasonable to consider 2009 as an interesting starting point as this was the first post-financial-crisis year.[13] At that time, the median chairman of an SMI company received around 5.7 times the pay of the median chairman of a small-cap company. Since then, this ratio has almost uniformly declined and is now at 3.5. Similarly, the median board member of an SMI company received around 3.5 times the pay of the median board member of a small-cap company in 2009. Since then, this ratio has almost monotonically declined to about 2.5.

[12] Because the structure of board pay has remained relatively constant, and because board pay is not typically performance-related, it is meaningful in this case to directly compare compensation amounts across years. (By contrast, in the analysis of executive pay in Section 4.4, we do need to take into account changing pay composition and company performance.)

[13] The years 2007 and 2008 are somewhat unusual, as becomes especially apparent when considering the SMI/Small-Cap ratio of median chairman pay. In 2007, median small-cap chairman pay had been unusually high, and in 2008 median SMI chairman pay had been unusually low, resulting in relatively low ratios in these two years.

Figure 13: Ratios of median chairman and board member pay



4.1.1 Implications

The increased convergence of board pay is not due to the larger companies paying their boards less, but due to a catch-up process taking place in the mid-sized and smaller companies. One interpretation of these findings is that while the job of a board member at a very large company has always been very demanding, it is – relatively speaking – at medium and smaller public corporations where the greatest additional demands on the competences and efforts of board members have surfaced.

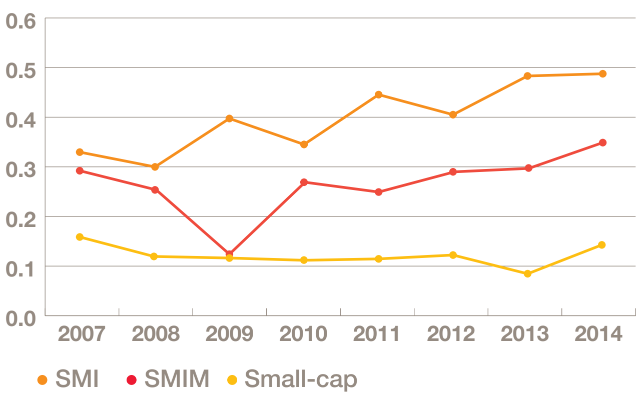
Here there are important implications for nomination and governance committees: as boards are constantly looking for appropriate and competent board members to support the company in these challenging times, it is important to be aware of the trends in relative board pay. Another dimension of the greater convergence in board pay across company size groups has to do with the incentives for board members. As discussed in last year's Insights, pay differentials between companies of different sizes bring with them a natural element of "career concern incentives".[14] The observed convergence in board pay tends to diminish this type of incentive.

14) Individuals are motivated not only by the incentive system in place in their current job, but they also arguably take into account that good performance now opens up better career opportunities – in particular, the opportunity to manage a larger, higher-paying firm – in the future. Conversely, they are aware that poor performance now is likely to result in fewer such opportunities in the future; indeed, poor managers may find themselves slipping down a notch or two in the size of the company they lead, which implies lower pay. When added up over the duration of a career, these forward-looking incentives can be substantial.

4.2 What is the connection between the composition and the level of pay?

Sections 3.4 and 3.6 highlighted some facts about the composition of pay in SMI, SMIM, and small-cap firms. In this section, our focus is on the ratio of equity-based compensation to total compensation (multiplied by 100). To begin with, Figure 14 considers the median CEO's percentage of equity-based pay. The median can generally be considered a more robust measure of "typical" values. In this particular case, similar observations can be made as were seen in the average numbers earlier. In particular, in SMI and SMIM companies, we see a trend towards the increasing use of equity-based pay for CEOs. Considering the median, the trends are particularly salient for the SMI companies, where equity-based compensation has increased from 33% in 2007 to 49% in 2014. Starting after the financial crisis, a powerful increase in equity-based compensation can also be observed for SMIM companies. From 2012 to 2014, we see an increase in the use of equity-based pay in all three groups of companies.

Figure 14: Percentage of equity-based pay of CEOs (medians)



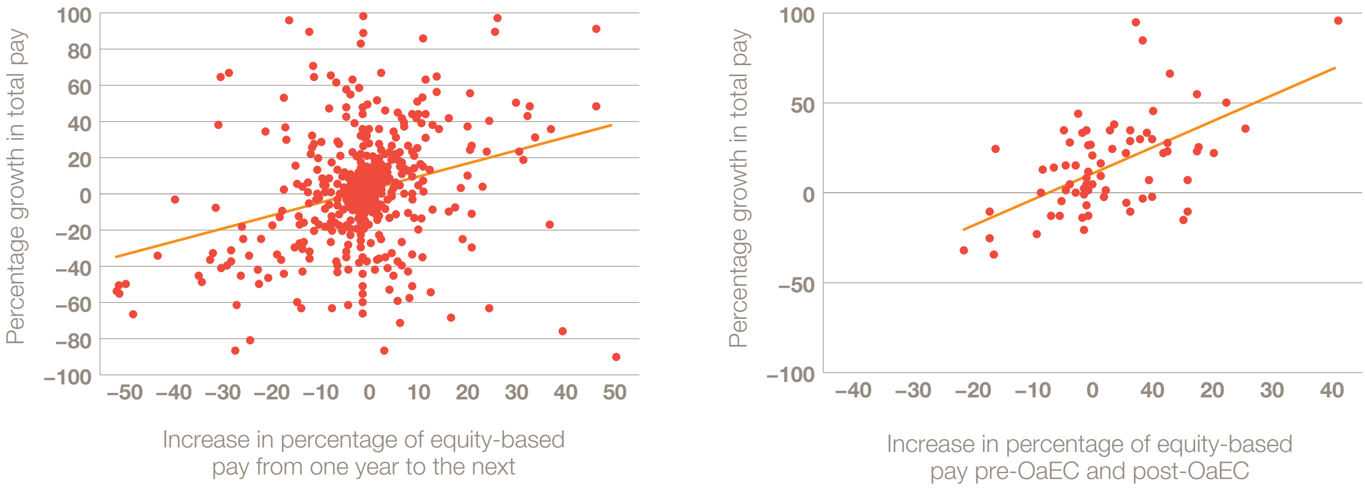
These observations are important to assess developments in pay levels. Consider Figure 15. The left panel of this figure shows all the data, from 2007 to 2014, of CEO pay composition and pay levels. The horizontal axis plots the change, from one year to the next (for example, from 2009 to 2010), in the percentage of total CEO compensation that is equity-based. Thus, +10 on this graph indicates that a CEO's percentage of equity-based pay increased from, for example, 30% to 40% from one year to the next. The graph indicates that on the individual CEO level, pay composition can be quite variable; this is not very surprising – company performance varies, and some companies provide one-off equity awards in a given year. The vertical axis plots the percentage growth in total CEO total pay from one year to the next. +20 on this axis indicates that CEO pay grows by 20%, for example, from CHF 1.6 million to CHF 1.92 million.[15]

The picture shows a striking result: The change in compensation is strongly positively related to the change in equity-based compensation. (Note that this analysis automatically takes out any differences among firms that remain constant over time. For example, this automatically adjusts for industry differences as well as for size differences.)

The right panel of Figure 15 shows the same analysis for a particularly interesting two-year change, namely, the time from 2012 to 2014. Many things arguably changed in the general corporate governance environment in Switzerland in this time period. Perhaps the most salient change was the adoption of the "Ordinance against excessive compensation in stock exchange listed companies" (OaEC) in 2013. Thus, in this case, the horizontal axis of the figure plots the change, from the year 2012 (pre-OaEC) to the year 2014 (post-OaEC), of the percentage of total CEO compensation that is equity-based. We note that this is a not a fully accurate measure of factual pay structure changes because variable compensation given for performance in 2015 is not captured yet. Moreover, for many companies, equity grants made in 2014 were not yet subject to say-on-pay votes. It is, therefore, not possible to say whether any changes in the pay structure occurred because of the new regulatory environment. But purely factually, as can be seen, a majority of firms increased the percentage of equity-based pay. And again we see that levels of compensation changed in line with the change in the composition of pay.

[15] For presentational purposes, the graphs do not show a few datapoints that exhibit very large compensation changes. In the quantitative results discussed in the text after the figure, all datapoints are included, except for the highest and lowest 1% of the variables of interest.

Figure 15: Relationship between the use of equity-based CEO pay and total CEO compensation



A regression analysis, which controls for many factors that influence pay (company size, performance, industry characteristics, etc.) implies that an increase in the percentage of equity-based compensation by 10 percentage points (for example, from 30% to 40%) from one year to the next comes along, on average, with an increase in total compensation of 9%. To interpret these numbers, suppose, for example, that a CEO is receiving a total compensation package valued at CHF 1 million, consisting of CHF 300,000 in equity and CHF 700,000 in cash. Thus, 30% of compensation is equity-based. The empirical analysis implies that a shift to a 40% equity-based compensation would be achieved by a total compensation package valued at CHF 1.09 million, consisting of CHF 436,000 in equity and CHF 654,000 in cash. Note that the equity-based payments increase by CHF 136,000, but in this case cash compensation does not decrease by CHF 136,000 but only by CHF 46,000 (resulting, in total, in an increase in compensation by CHF 90,000). Indeed, conceptually, it is very likely that cash compensation does not go down as much as equity-based compensation goes up – a Swiss franc delivered in equity is worth less to a CEO than a Swiss franc conveyed in cash. Since equity-based compensation is more risky and executives tend to be under-diversified and risk-averse, they typically require a risk premium for taking on equity-based compensation.[16] Thus, there is not a simple substitutive relationship between various components of pay.

4.2.1 Implications

One immediate key implication of this analysis is that compensation benchmarking which does not take into account pay structure differences is fundamentally flawed. This would be akin to comparing the returns on equity of two companies A and B, where company A has no debt and company B has a significant amount of debt. Unfortunately, in their compensation reports until now companies have rarely presented a discussion of whether the companies they are benchmarking to are, in fact, using similar compensation structures. In our opinion, this practice is simply wrong and should be changed. We also emphasize the fact that in benchmarking exercises, it is particularly important to be clear about the differences between target and actual compensation, and the difference between grant values and actual vesting values of equity.

Another implication is that when wishing to align executives more strongly with shareholder interests, board members (and shareholders) may need to be prepared to provide overall greater compensation amounts. If performance conditions are used, it is important to set reasonable goals to ensure that (risk-averse) executives still put a value on equity-based compensation and will be motivated by the compensation package.

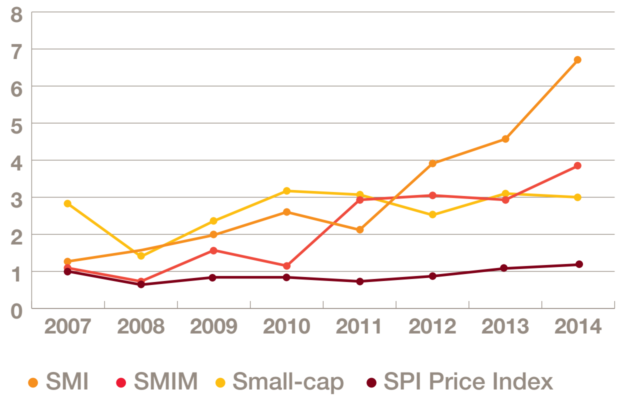
[16] The PwC study "The psychology of incentives" provides direct evidence from surveys of executives on this point.

4.3 How well-aligned are executives with their companies' fortunes?

A topic that is rarely addressed in the public discussion on executive pay but which nonetheless is of potentially great importance is the direct alignment of the interests of executives with the wealth of shareholders through executive share ownership. Sections 3.5 and 3.6 of this report discussed the absolute wealth changes of top management members. In this section, we put these numbers into greater perspective by directly considering ownership at the end of each year.[17]

Specifically, we compute, for each CEO, the ratio of wealth to base salary. Figure 16 plots the median of the resulting ratio. The figure shows a striking development in SMI and SMIM companies. Consistent with international trends, Swiss CEOs of these companies are holding increasing multiples of base salary as equity. While in 2008, the median ratio of equity wealth to base salary was around 1.6 and 1 in SMI and SMIM companies, respectively, this ratio has increased to almost 7 and 4, respectively. Additional analysis (not shown in the graph) reveals that, in SMI and SMIM companies, both the lower quartile and the upper quartile of the wealth lever have been trending upwards, especially in the last three to four years. Interestingly, in small-cap companies, at the beginning of the sample period, the upper quartile of the wealth lever was actually the highest among the three groups of companies, but it has since significantly decreased (due to a combination of increases in base salary in the lower quartile and a decrease in shareholding wealth in the upper quartile). In small-cap companies, since 2008, the equity wealth multiple has increased to 3. The graph also shows the development of the SPI price index, which is normalised to 1 for 2007. For this analysis, the price index, not a total return index is relevant. The graph suggests that the general development of the stock market explains relatively little of this overall development for SMI and SMIM companies. For small-cap companies, in fact, in recent years the stock market has been growing faster than the equity holdings of the median CEO.

Figure 16: Equity wealth as a multiple of base salary (medians)



4.3.1 Implications

Overall, we are witnessing an increase in the wealth lever especially in the SMI and SMIM companies. This occurs both on the extensive and the intensive margins: firstly, more CEOs are holding equity and the proportion of CEOs who do not hold any shares has dropped sharply in the past seven years. Second, those who already hold equity hold large positions (and/or do not sell the shares even though share prices have increased). CEOs of small-cap companies appear to be lagging behind the market in terms of their exposure relative to their base salaries. Boards of companies of all sizes should keep these facts in mind as they consider shareholding requirements. It may also be appropriate for companies to emphasize this dimension of alignment of management with shareholders more in their compensation reports.

[17] In interpreting the results in this section, it is important to keep in mind that ownership of course not only derives from equity-based compensation but also from stock purchases by management. Several companies are putting in place shareholding ownership requirements. The numbers reported here also include vested and unvested shares; they do not include options.

4.4 *How should companies prepare for next year?*

Naturally, a major focus of companies in the past year has been to prepare for the proxy season 2015 in order to successfully pass say-on-pay votes. We understand the immediate needs and the specific goal of achieving a positive vote outcome. Nonetheless, we feel that many companies could more pro-actively use the say-on-pay framework that Switzerland has in place now to specifically review the workings of their compensation system. We also feel that it would be dangerous for companies to sit back in light of the fact that in the 2015 proxy season, the binding say-on-pay votes held in compliance with the "Ordinance against excessive compensation in stock exchange listed companies" have so far all been approved with very large majorities; shareholders have expressed some concern by occasionally high negative votes in advisory votes on compensation reports. There is not a single best practice as regards the disclosure of information, nor is there a best practice as regards the compensation system itself. Importantly, as we documented in last year's Insights, proxy advisors disagree far more frequently than is commonly assumed, so it is also not possible to "simply" rely on proxy advisors' voting guidelines. Instead, boards of directors, executive management as well as investors – in particular institutional investors such as pension funds – have the responsibility to consider what is the appropriate design and disclosure of compensation matters in the specific context of a given company. An ongoing dialogue between boards of directors, investors, and other stakeholders is then essential for fostering the long-term positive development of companies. In some specific cases, as predicted in last year's Insights, the way in which some companies have chosen to present their AGM materials essentially shows that an exciting new "language" is developing through which companies communicate their plans to shareholders.

In our view, there is a close connection between the compensation report and the documentation relating to the binding votes on pay enclosed with the invitation to the AGM. The vote on compensation to boards of directors is generally taken on an AGM-to-AGM basis (while the compensation itself is valid for the financial year, as it was previously). On the other hand, practices vary widely when it comes to the system chosen for the vote on executive board pay. Around two-thirds of entities hold a mainly prospective vote, while a third have opted for a mixed approach. Mixed approaches generally involve a prospective vote on salary and a retrospective vote on the bonus (short-term incentives or STIs), while votes on long-term incentives (LTIs) take a variety of forms.

In the course of our series of Compensation Committee Luncheons we get to talk to companies, investors and proxy advisors on a regular basis. From this dialogue and our experience with AGMs in 2014 and 2015, we have found that three questions dominate when it comes to retrospective votes – and these questions should also inform the review of compensation systems itself, not merely the disclosure or the preparation of the AGMs:

1. Is the amount proposed justifiable and complete?
2. Is the relationship between pay and performance adequately explained? In other words, is the proposed pay – including compensation amounts in the prior reference period – justified in terms of performance?
3. In cases where the system is not purely formula-based, is the procedure for deciding bonuses clear and transparent?

Naturally the compensation report is a particularly important vehicle for this information for retrospective votes, because in this case it refers to the time period in which the vote is held. Some additional information may be provided in the AGM material.

For prospectively voted compensation components, the ways in which information can be provided vary widely. The compensation report can be a significant source of information for such votes. When it comes to the vote on granting compensation, it is important not just to describe the compensation system used in the past. Shareholders need either an indication that the compensation system (and the way it is adjusted) will remain unchanged in the period targeted by the prospective vote, or an explanation of how the system is going to function in the future. This forward-looking information can also be presented in the AGM documentation. Finally, to a certain extent a company can promise shareholders that there will be detailed reporting in future compensation reports. Of course this promise will be more credible if the organisation agrees to hold a consultative vote on future reports and if in general the company has acted in a trustworthy manner in the past.

In terms of substance, when it comes to pay components subject to a prospective vote, investors and proxy advisors primarily ask the following eight questions – and again these questions should also inform the review of compensation systems itself, not merely the disclosure or the preparation of the AGMs:

1. Is the amount proposed justifiable and complete?
2. Is the comparison between the targeted maximum and compensation in the prior period meaningful (i.e., done on a like-for-like basis)?

3. Are the reasons given for any divergence in total compensation, or parts of it, and pay in the prior reference period reasonable and justified?
4. Do shareholders know how total compensation breaks down into the various pay components?
5. Does the proposal make clear why the proposed system and amounts are deemed to be reasonable?
6. Variable incentive programmes: are the mechanisms for determining STIs and LTIs reasonable and comprehensible? Are shareholders told how they create incentives for management?
7. LTI programmes: do shareholders find out whether actual distributions will be disclosed in future compensation reports?
8. Is the procedure for management compensation transparent?

Overall, we recommend our clients to use the opportunity of say-on-pay to review and, where necessary improve the mechanics of their compensation systems, and not to be afraid to engage their major shareholders in a constructive dialogue. Of course, there is always a challenge as regards the equal treatment of shareholders, but this challenge can be successfully navigated. When boards of directors realise that institutional investors are not "out to get them" but are (also) interested in the long-term success of the company, a successful cooperation will occur that supports long-term value-creation for all concerned.

4.5 Special technical analysis: What has happened to "excessive" variable compensation packages?

This section addresses the question whether companies with previously "excessive" variable compensation packages have recently adjusted their pay policies. Because the analysis employs somewhat more technical economic and statistical tools, this section is placed at the end of this report.[18]

4.5.1 Asking the "right" question

Much of the public discussion has focused on the question whether pay levels in general would decrease due to recent regulatory efforts, due to the adoption of the *Abzocker-Initiative*, as well as due to the general change in the public climate regarding corporate governance and executive compensation. While this discussion is emotionally appealing, it is unfortunately rather misguided, or at least incomplete. A simple set of descriptive statistics of executive pay before and after the adoption of a certain law, for example, cannot hope to capture the many other things that are changing in companies around the same time. Moreover, because companies differ (for example, in terms of size and industry), mixing them together without accounting for their differences is likely to produce fuzzy results at best.

Besides being a difficult question to answer, in our opinion the question whether pay levels in general would decrease is also the wrong question to ask. Instead, we argue that shareholders (and the public) should (mostly) worry about excessive or abnormal pay. Although the term "abnormal" may conjure up a medical context, this term is quite frequently used in the economics and financial literature to denote phenomena (for example stock returns) that are higher or lower than expected, given some model. An important point regarding abnormal compensation is that a given CEO can be either "overpaid" or "underpaid". Indeed, by definition, if there are some CEOs who are receiving higher pay than expected given company characteristics and their performance, then there must also be some CEOs who are receiving less compensation than expected. In other words, not all CEOs are paid above average.

Do shareholders care about abnormal pay? Research conducted at the University of Zurich has shown that they do. For example, there was great heterogeneity in the share price reactions of Swiss companies to the *Abzocker-Initiative*. While some companies lost significant value, others gained. Importantly, the study showed that share price reactions to the new shareholder rights were relatively more favourable in those companies that offered their CEOs substantial amounts of abnormal pay. This suggests that shareholders expected these companies to change their compensation policies and to therefore unlock value. That analysis raises the question, however: did companies really systematically change?

[18] The findings reported here draw on Wagner and Wenk, Agency vs. hold-up: on the impact of binding say-on-pay on shareholder value, Swiss Finance Institute – University of Zurich working paper, 2015, available for download at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1793089

The next subsection explains the method to answer this question. Readers interested primarily in the bottom line can jump to Section 4.5.3.

4.5.2 Background: The method

In the first step of our analysis, we compute abnormal levels of variable compensation (cash and equity bonuses). We do so by regressing (the logarithm of) variable compensation on a large set of explanatory variables known to influence pay: firm size, performance (share returns relative to a peer group), a variable indicating whether a CEO is also a board member or chairman, firm fixed effects (that is, a variable that allows each company to have its own “culture” or “style” of compensation), and year dummies. Such a regression explains roughly 80% of the variation in variable compensation. (Instead of firm fixed effects, we can also use industry fixed effects, in which case about 60% of the variation is explained, but essentially identical results obtain below.)

What we are interested in is the residual, that is, the unexplained part of this regression. If actual variable compensation is greater (smaller) than what is predicted by the listed firm characteristics in a given year, then we say that a CEO received abnormally positive (negative) variable compensation in that year. The ratio of actual variable pay to predicted variable pay is the abnormal variable pay ratio. This number is greater than one for “overpaid” CEOs. Over the whole sample period, the first quartile is about 0.5, meaning that one quarter of CEOs are paid around half of the bonus that would be expected given the above empirical model. The third quartile is about 2.5, meaning that one quarter of CEOs are paid around 2.5 times the bonus that would be expected given the above empirical model. Naturally, the median is about 1. The mean is greater than one due to some large positive abnormal pay amounts. In 2012, the mean was about 1.7, in 2014, it was about 1.4.

But we are not interested in averages here. Instead, the question is whether those companies that overpaid their CEOs in 2012 adjusted their pay practices towards more “normal” variable compensation.

Denote by “Overpaid-2012” those firms that paid their CEO in the year 2012 variable compensation that was abnormally large, and by “Underpaid-2012” those firms that paid their CEO in the year 2012 variable compensation that was abnormally small. We then consider how the compensation of a firm that had excessive pay practices in 2012 developed in the following two years. As this was a time of significant shifts in the corporate governance environment in Switzerland (the *Abzocker-Initiative* was accepted in 2013, the OaEC was finalised in 2013 and entered into force in 2014, and generally a significant support for changes in corporate governance was evident in public opinion), a natural comparison is to compare the year 2012 with the years 2013 and 2014 (but similar results hold also when comparing 2012 and 2014 only).

Specifically, in the second step of our analysis, we run a regression of the following form:[19]

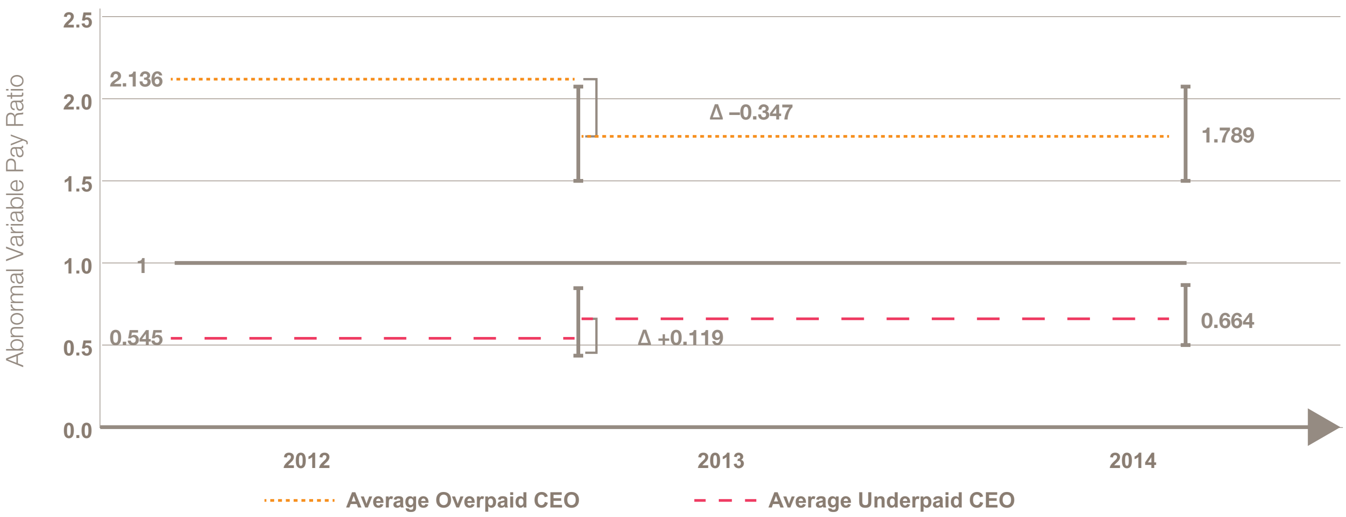
Abnormal variable pay ratio for CEO of firm i in year t =
a + b1 * Dummy (CEO in firm i was Overpaid-2012) * Amount by which CEO in firm i was overpaid * Dummy (years 2013 and 2014)
+ b2 * Dummy (CEO in firm i was Underpaid-2012) * Amount by which CEO in firm i was underpaid * Dummy (years 2013 and 2014)
+ G * control variables + firm fixed effects + error term

In this specification, the coefficient b1 captures the change in the abnormal variable pay ratio of Overpaid-2012 type firms in the years 2013 to 2014 compared to (hypothetical) firms that paid their CEO the normal variable compensation. And the coefficient b2 captures the change in the abnormal variable compensation of Underpaid-2012 type firms in the years 2013 to 2014 compared to (hypothetical) firms that paid their CEO the normal variable compensation. In other words, the regression allows for different effects for overpayers and underpayers. We also add a rich set of control variables (details are available on request). We include firm fixed effects to control for any unobservable fixed firm characteristics that may drive compensation.[20]

[19] This approach follows the investigation of the impact of the Sarbanes-Oxley Act on compensation in the US in Chhaochharia and Grinstein, 2009, CEO compensation and board structure, The Journal of Finance, 64, 1, pp. 231-261.

[20] We emphasize that the interpretation of these results depends to some extent on whether we have correctly specified the model of abnormal variable compensation. It is conceivable that a factor is omitted in the model that explains part of compensation. Suppose, for example, that we have omitted one variable that would rationally explain higher compensation. Thus, for companies scoring highly on that omitted variable, we are then incorrectly inferring positive abnormal compensation levels. If these companies then systematically have lower compensation in the post-2012 time period, we would incorrectly find that companies with high abnormal compensation in 2012 had lower abnormal compensation in the post-2012 period. Note, however, that because we are controlling for firm fixed effects and a large number of other controls, this concern is substantially ameliorated.

Figure 17: Abnormal variable pay from 2012 to 2014



4.5.3 Findings

We obtain strong evidence that abnormal variable pay changed from 2012 to 2013/14. Importantly, abnormal variable pay changed systematically, namely, according to whether the CEO had received excessive or too small bonuses in 2012.

Figure 17 illustrates the results. Among those CEOs that were overpaid in 2012, the average abnormal pay ratio was 2.14 (dotted line). This means that among these CEOs, variable compensation was 214% of what it should have been, given the size, performance, and other characteristics of the firm. The regression analysis suggests that for this type of firm the abnormal pay ratio was reduced to about 1.79 in the years 2013 and 2014. Of course, these estimates come with some statistical uncertainty, but the 95% confidence interval of this estimate is quite narrow, between 1.5 and 2.1.

To some extent, the flip side is that, as Figure 17 shows, previously underpaid CEOs (dashed line) are now also closer to the expected variable compensation levels. However, for CEOs underpaid in 2012, the estimates are not quite as precise so that overall there is no statistically significant evidence that abnormal variable compensation in fact increased for this group of companies.

4.5.4 Implications

What should managers and policy-makers make of all this? The interpretation of the findings is subtle: The results do not mean that pay levels have decreased or will decrease. They also do not mean that excessive pay can be avoided by regulation. Instead, the interpretation is that after 2012 Swiss companies have adjusted variable pay to be more in line with "optimal" or "expected" values, and that the effect was particularly pronounced for firms that were previously overpaying. As food for thought, we might speculate that what we are seeing is the effect of market forces combined with a push by public opinion and regulation such as the new say-on-pay regime, whose potential disciplinary effects may already to some extent be anticipated by companies. But a definitive assessment of these intriguing questions is difficult. It also remains to be seen whether the effects identified will be sustained over time.

As shareholders, proxy advisors, and the public become more attentive to abnormal compensation, for board members and managers the results suggest that it has now become even more important to make sure that pay is closely related to performance and appropriate in light of the size and type of the company.

5 Concluding Remarks: Six Principles

Despite – or because of – the market fluctuations we have seen over the past years and the many new regulatory challenges companies face, we continue to recommend that executive compensation should be designed with six simple principles in mind.

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 needed in 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.

Chairman								SMI		SMI Changes
	2007	2008	2009	2010	2011	2012	2013	2014	2013/2014	2007–2014
Highest	14,624,000	15,228,951	15,116,196	10,599,302	13,500,946	13,067,592	8,778,814	6,329,765	–27.90 %	–56.72 %
Upper Quartile	2,267,343	2,510,380	3,070,609	5,170,938	3,901,563	4,744,835	4,193,723	3,793,850	–9.54 %	67.33 %
Median	981,479	849,045	1,330,867	1,288,694	1,359,124	1,139,932	1,140,754	1,103,368	–3.28 %	12.42 %
Lower Quartile	540,402	752,011	670,599	621,725	817,837	611,893	620,260	634,076	2.23 %	17.33 %
Lowest	277,000	157,000	256,570	145,845	179,230	199,230	200,316	231,378	15.51 %	–16.47 %
Average	2,388,680	2,452,604	2,954,167	2,984,783	2,972,324	2,985,809	2,435,080	2,138,133	–12.19 %	–10.49 %

Board of Directors								SMI		SMI Changes
	2007	2008	2009	2010	2011	2012	2013	2014	2013/2014	2007–2014
Highest	5,027,381	2,901,796	5,274,667	6,034,881	2,390,000	2,556,000	2,708,134	2,502,481	–7.59 %	–50.22 %
Upper Quartile	400,030	374,497	408,169	427,780	423,935	397,445	400,951	384,495	–4.10 %	–3.88 %
Median	297,059	279,869	317,407	327,388	323,680	326,376	318,411	307,620	–3.39 %	3.56 %
Lower Quartile	176,794	170,000	189,000	216,991	229,308	217,098	228,806	232,364	1.56 %	31.43 %
Lowest	0	0	0	0	0	0	0	0	0.00 %	0.00 %
Average	380,461	355,828	413,729	413,077	375,373	363,348	379,753	363,180	–4.36 %	–4.54 %

CEO								SMI		SMI Changes
	2007	2008	2009	2010	2011	2012	2013	2014	2013/2014	2007–2014
Highest	22,280,000	20,544,032	20,471,929	12,760,000	15,722,386	13,228,188	13,226,287	13,247,004	0.16 %	–40.54 %
Upper Quartile	13,136,500	8,363,477	12,239,331	8,696,498	9,322,764	9,303,409	10,025,031	9,804,585	–2.20 %	–25.36 %
Median	8,093,387	5,318,957	5,487,132	7,631,875	5,820,000	6,707,148	6,668,465	7,453,575	11.77 %	–7.91 %
Lower Quartile	4,682,601	3,466,990	3,821,146	5,220,068	5,315,541	4,795,092	4,510,798	5,606,639	24.29 %	19.73 %
Lowest	1,704,000	1,814,702	1,819,000	1,560,206	1,570,000	1,652,000	1,713,000	1,773,000	3.50 %	4.05 %
Average	9,470,696	6,989,794	7,971,237	7,159,064	7,208,376	7,142,766	7,143,090	7,556,979	5.79 %	–20.21 %