Say-on-Pay and the Value of Swiss Corporations

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By

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Abstract

The Swiss entrepreneur Thomas Minder recently entered the federal initiative „against rip-off salaries” which, amongst other things, is aimed at giving shareholders a binding vote on the compensation of board and management. Significant negative abnormal returns were observed around the day the initiative committee announced to have collected enough signatures for a popular vote. Furthermore, the negative market reaction was especially pronounced for firms with modestly overpaid CEO’s and corporations with good corporate governance. The findings suggest that for these firms the initiative just proves to be further costs without adding sufficient benefits to offset the expenses.

January 2010

Executive Summary

The financial crisis pierced through the economic landmark like no other crisis since the great depression in the thirties of the last century. This was an ideal breeding ground for all kinds of regulatory propositions with say-on-pay being the last outflow to increase shareholders power and voting right in the boardroom. In Switzerland, it was Thomas Minder who started a federal initiative "against rip-off salaries" that wants to give shareholders a louder voice regarding total compensation of the firms' executives and board members. To understand what impact an approval would have on the Swiss economy one needs to know the corner pillars of the initiative.

"The initiative demands that:

- shareholders of Swiss listed companies must validate the total of all remunerations of the board of directors and of management on an annual basis
- termination pays, advance payments as well as bonuses in the event of company sales be forbidden
- pension funds (including AHV funds [Swiss old-age and survivors' insurance]) be obliged to vote at general meetings in the interest of their insured customers and to disclose their voting behaviour
- the shareholders be allowed to distance vote electronically (without being physically present at the general meeting)
- the shareholders fix the number of additional positions (outside the group) of board members

Through these and other measures, enrichment at top management level can finally be put paid to, and democracy for shareholders can be improved."[1] As reported by Economiesuisse, which compared the stock corporation law of different countries, the initiative is going far beyond the international developments especially in the area of executive compensation.[2]

After the public outcry the bonus affair around UBS produced in the beginning of 2009 one could argue that there is in fact a problem with executive compensation, be it just a matter of violating public moral conception. However, it needs to be distinguished between the real

[1] Cf. http://www.ripoff.ch/news.html, 19.11.2009 (Query).
[2] Cf. Anonymous: Economiesuisse warnt vor Überregulierung durch »Abzocker-Initiative«; Initiative gefährde Unternehmensstandort Schweiz, Associated Press Worldstream, 18.11.2009, LexisNexis.

public opinion and the financial populism the tabloids and newspapers produced. According to the latest public opinion poll in June 2009 it would receive approval of 75% of all people who are eligible to vote.[3] This shows that most people seem to have the feeling that there is indeed something wrong with the current compensation practice of public companies and it also illustrates that there exist few matters amid management and shareholders that are as contentious as executive compensation.

According to Bainbridge (2008) the proponents of federal legislation entitling shareholders to vote on executive compensation need to prove three distinct claims. Firstly, that there is in fact a problem with executive compensation justifying legislative intervention. Secondly, that the problem needs to be solved by imposing legislation at federal level. Thirdly, that say-on-pay is an effective answer to the problem.[4] After discussing the first two points the paper focuses on the third part by trying to answer if say-on-pay is in fact an effective solution to the problem at hand i.e. will allowing shareholder votes on executive compensation create value.

For this reason the author performs three experiments. Firstly, to see how the market reaction was for the Swiss 'Say-on-Pay' legislation an event study is performed. With this method any significant positive or negative abnormal returns that appeared during a certain period can be measured. To identify on which date the perceived eventuality of an enactment had increased the most a search on the website of the Federal Chancellery is executed. To make sure a date isn't tested where confounding events distort the results and therefore lead to a wrong interpretation the financial headlines around the world are dissected. After carefully examining all dates that qualify to get tested the author focuses on the day the initiative committee announced it had gathered the needed 100'000 signatures. Of course it has to be noted that even if abnormal returns are to be found the impact is likely to understate the economic significance of shareholder's say-on-pay because of the uncertainty of the vote's outcome.[5] Nonetheless, the author finds that there are in fact significant abnormal returns during the determined key event. In contrast to the results Cai and Walkling (2009) find in their analysis for the U.S. market, the results for Switzerland indicate that the investors evaluate the initiative as negative. Secondly, it is examined whether a relationship exists between abnormal CEO compensation and abnormal returns during the event window. For this reason two models are constructed to measure abnormal CEO compensation. The results

[3] Cf. Müller, A.: Falsche Anreize beseitigen, in: SonntagsZeitung, 14.06.2009, LexisNexis.
[4] Cf. Bainbridge, S.: Remarks on Say on Pay: An unjustified incursion on director authority, 2008, p. 1.
[5] Cf. Cai, J. / Walkling, A.: Shareholders' Say on Pay: Does It Create Value?, 2009, p. 4.

give evidence that for firms with underpaid CEO's the initiative could prove beneficial. Concerning the rest however, the market seems to value the initiative as disadvantageous especially for firms with modestly overpaid CEO's. This leaves room for the interpretation that for investors the biggest concern is if they have the right people as executives rather than if they earn too much. Thirdly, it is examined whether a relation exists between the abnormal returns found and good or bad corporate governance. For this reason five governance variables are determined for a well diversified subset of firms in the SPI® universe. The results indicate that firms which can be considered to have exemplary corporate governance structure – in case of the particular governance variable looked at – are the ones that got punished the most by the market in the three day event window. Furthermore, the firms with the weakest corporate governance are penalized the least indicating that the market values the initiative as less disadvantageous to them because an implementation of the initiative into the legislation would increase the transparency and give shareholders more access to the proxy.

This study provides evidence on how the market values the possible implementation of say-on-pay into law. Contrary to the results of the public opinion pool the market assesses the initiative as unconstructive. From a scientific point of view there are good arguments for and against an implantation into law. Advocates argue that the initiative helps in further aligning the interests of the shareholders with the management and that it increases shareholder democracy.[6] Opponents fear that it will give power to investors that are driven by special interests and that it decreases the authoritative control of the board of directors which makes corporations practicable in the first place.[7] Furthermore, they fear that in the event of a possible enactment an overregulation is the consequence which threatens the attractiveness of the Swiss economy as a whole and as a consequence could provoke corporations to leave the country with jobs and tax revenue going with them.[8] In the author's opinion the outcome of the vote relies predominantly on the date the federal vote is placed and on the state of the economy on that given date. There is also a question mark if the public authorities react with a less extensive counterproposal in the hope that it would rather be accepted by the public.

[6] Cf. Cai, J. / Walkling, A.: Shareholders' Say on Pay: Does It Create Value?, 2009, p. 30.
[7] Cf. Bainbridge, S.: Remarks on Say on Pay: An unjustified incursion on director authority, 2008, p. 8-10.
[8] Cf. Unknown author: Economiesuisse warnt vor Überregulierung durch »Abzocker-Initiative«; Initiative gefährde Unternehmensstandort Schweiz, Associated Press Worldstream, 18.11.2009, LexisNexis.

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In the wake of the recent financial crisis and bonus earnings of the top management of corporations in the financial sector the sentiment of the general public towards management compensation has taken a turn from silent acceptance to large disapproval. This is a trend that can be observed in almost any Western country with leaders of the European Union in particular being keen on strengthening the supervision over the financial markets.

In Switzerland it was especially the bank UBS that has been heavily criticized for giving its employers large bonuses despite needing a bailout plan orchestrated by the Swiss federation and the central reserve bank to avoid a looming collapse. The public debate hit its climax after UBS announced that it would still spill bonuses for the crisis-ridden year of 2008. Although the company announced it would be limited to 2 billion Swiss francs, which is a reduction of about 80% to the year before, the broad public was not amused.[9] This example illustrates that there exist few matters amid management and shareholders that are as contentious as executive compensation.

Even the minister of economic affairs, Doris Leuthard, said in an interview in 2009 with the Tages-Anzeiger: “For me it’s clear that the difference in payment between the banking sector and the other industries has become too great. The payrolls of bankers have to decrease” In the same interview she stated: “It’s no business of the state to decide how big the compensation of the management has to be. It lies within the competence of the shareholders. That’s why the Federal Council of Switzerland wants to strengthen the rights of the shareholders.”[10]

In previous years, it wasn’t so much the bonus payments or the overall compensation of bankers that stirred up public emotions and indignation. Rather, the public anger was directed at the payment of few individuals, namely the list of the best paid mangers in the country. These stories often filled the headlines of the local press along with reports of golden parachutes or option repricings.[11]

However, it was in late 2006 that the Swiss entrepreneur Thomas Minder had started the federal initiative “against rip-off salaries” (hereafter Say-on-Pay Initiative) which was long

[9] Cf. Unknown author: UBS / Nationalbank und Merz geben Grossbank bei Boni Rückendeckung, in: AWP Premium Swiss News (German), 02.02.2009, LexisNexis.

[10] Cf. Schnyder, S.: «Die Löhne der Banker müssen sinken», in: Tages-Anzeiger, 31.01.2009, LexisNexis.

[11] Indeed, a quick survey through LexisNexis reveals more than enough examples. Here are some of the headlines found (in German): Die moralische Seite des Versagens bleibt (Tages-Anzeiger, 10.10.1998); Vergoldete Topmanager (SonntagsZeitung, 19.03.2000); ABB-"Abzocker" zahlen 137 Millionen Franken zurueck (Associated Press Worldstream, 10.03.2002); Super-Dan dreht auf (SonntagsZeitung, 08.06.2003); Dosé soll von Bord - aber ohne goldenen Fallschirm (Tages-Anzeiger, 27.06.2003); Heroin fuer Manager (FACTS, 19.05.2005); Ein Abgang, der sich lohnt (HandelsZeitung, 26.10.2006).

before the financial crisis really hit the ground. Naturally, it built up a tremendous amount of momentum during the last few months. To understand what impact an approval would have on the Swiss economy one needs to know the corner pillars of the initiative.

“The initiative demands that:

- shareholders of Swiss listed companies must validate the total of all remunerations of the board of directors and of management on an annual basis
- termination pays, advance payments as well as bonuses in the event of company sales be forbidden
- pension funds (including AHV funds [Swiss old-age and survivors' insurance]) be obliged to vote at general meetings in the interest of their insured customers and to disclose their voting behaviour
- the shareholders be allowed to distance vote electronically (without being physically present at the general meeting)
- the shareholders fix the number of additional positions (outside the group) of board members

Through these and other measures, enrichment at top management level can finally be put paid to, and democracy for shareholders can be improved.”[12]

As reported by Economiesuisse, which compared the stock corporation law of different countries, the initiative is going far beyond the international developments especially in the area of executive compensation. Opponents fear that in the event of a possible enactment an overregulation is the consequence which threatens the attractiveness of the Swiss economy as a whole and as a consequence could provoke corporations to leave the country with jobs and tax revenue going with them.[13] Hofstetter (2002) writes in this context that it must not be forgotten that deviations from international standards can lead to locational advantages and that with restrictions on entrepreneurial freedom competitive advantages could be given away.[14] Additionally, foreign firms which considered moving to Switzerland could be tempted to go somewhere else. Rolf Watter, partner of the law company Bär & Karrer, fears

[12] Cf. http://www.ripoff.ch/news.html, 19.11.2009 (Query).
[13] Cf. Unknown author: Economiesuisse warnt vor Überregulierung durch »Abzocker-Initiative«; Initiative gefährde Unternehmensstandort Schweiz, in: Associated Press Worldstream, 18.11.2009, LexisNexis.
[14] Cf. Hofstetter, K.: Corporate Governance in der Schweiz, 2002, http://www.six-exchange-regulation.com/download/admission/being_public/governance/cg_ch_de.pdf, 22.12.2009 (Query).

that the board of directors could be substantially handicapped in selecting and hiring executives and as a result is hindered in organizing the firm in alignment with its business needs. The board could face, for instance, difficulties in bargaining on the salary of a possible executive manager currently employed by another firm because it is not definite until the general assembly decides on it.[15]

Almost exactly two years after Thomas Minder started the Say-on-Pay Initiative the foundation Ethos and eight pension funds demanded that five large Swiss companies adopt an advisory vote on compensation design and compensation report.[16] In January 2009 three of them reported they would apply say-on-pay at their next general assembly which was a first achievement for Ethos and their meanwhile over 30 companies containing supporting group of Swiss and international firms. All together this assembly manages funds of over 250 billion Swiss Francs which naturally adds considerably to their weight.[17] A month later Novartis, one of the two firms who didn't automatically adopt say-on-pay as demanded, let their shareholders vote if they want to approve an advisory vote on executive remuneration. The shareholders rejected the proposal with a two-third majority. The vote generated big interest because Novartis' president and CEO Daniel Vasella is year after year one of the best paid managers in the country. During the very same day the Novartis share lost partially over 4% and closed with minus 1.9%. Even though the proposal was declined Ethos and its partners valued it as a success and since then started several new demands on other large corporations.[18]

According to Bainbridge (2008) the proponents of federal legislation entitling shareholders to vote on executive compensation need to prove three distinct claims. Firstly, that there is in fact a problem with executive compensation justifying legislative intervention. Secondly, that the problem needs to be solved by imposing legislation at federal level. Thirdly, that say-on-pay is an effective answer to the problem.[19]

The first claim can be looked at by a large spectrum of different perspectives. There is the emotional aspect. After the public outcry the bonus affair produced one could argue that there

[15] Cf. Unknown author: CH/Economiesuisse: Abzocker-Initiative bringt Schweiz Überregulierung, in: AWP Premium Swiss News (German), 18.11.2009, LexisNexis.
[16] Cf. Unknown author: CH/Ethos fordert Konsultation der Aktionäre bei Managergehältern, in: AWP Premium Swiss News (German), 23.09.2008, LexisNexis.
[17] Cf. Anonymuous: Ethos: Konsultativabstimmungen bei Novartis und ABB nicht vom Tisch (2.AF), in: AWP Premium Swiss News (German), 23.01.2009, LexisNexis.
[18] Cf. Unknown author: Novartis-Aktionäre wollen nichts von Konsultativabstimmung wissen; Ethos-Antrag mit Zwei-Drittels-Mehrheit abgeschmettert - Vertrag mit Vasella verlängert, in: Associated Press Worldstream, 24.02.2009, LexisNexis.
[19] Cf. Bainbridge, S.: Remarks on Say on Pay: An unjustified incursion on director authority, 2008, p. 1.

is in fact a problem with executive compensation, be it just a matter of violating public moral conception. Of course it needs to be distinguished between the real public opinion and the financial populism the tabloids and newspapers produced. According to the latest public opinion poll in June 2009 it would receive approval of 75% of all people who are eligible to vote.[20] This shows that most people seem to have the feeling that there is indeed something wrong with the current compensation practice of public companies.

Then there is the scientific, unemotional point of view. In the principal-agent theory, which was first outlined by Jensen and Meckling (1976), the owner (principal) and the manager (agent) have partially contrary interests because of asymmetric information and missing institutions. For the manager it is advantageous to take actions that are good for him regardless if it harms the owner. This is due to the fact that the manager gains the revenue of his actions but the costs accrue (partially) on the principal. To align the interests of the manager with the interests of the owner the owner is set to make proper incentives for the manager.[21] In theory, this could be made possible by efficient compensation contracts. The problem with big public companies is that there are thousands of shareholders which makes it impossible for the shareholders to write those contracts themselves. This is why that duty is delegated to the board of directors which acts as their representative.

Bebchuk and Fried (2004) point out that the typical assumption of executive compensation is that pay arrangements are produced by arms-length contracting, meaning that the managers are trying to get themselves the best possible deal and the board is looking for the best deal for the shareholders. This acknowledges the fact that managers are subject to an agency problem and do not automatically seek the maximization of shareholder value. They show, however, that the process in which payment is determined in today’s public companies deviated strongly from the arm’s-length model. Accordingly, today’s executives are exerting considerable influence over their boards and de facto setting their own compensation.[22] As Bebchuk and Grindstein (2004) show this excess pay the managers receive because of their power is hardly a pocket change for the shareholders and if one could cut these compensation levels by keeping the incentives the same it wouldn’t be merely symbolic but instead have a real and a perceivable impact on the corporate earnings.[23] This example of the pervasive role of managerial power is an essential variable in explaining the contemporary landscape of the

[20] Cf. Müller, A.: Falsche Anreize beseitigen, in: SonntagsZeitung, 14.06.2009, LexisNexis.
[21] Cf. Jensen, M. / Meckling, W.: Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, 1976, p. 305-313.
[22] Cf. Bebchuk, L. / Fried, J.: Pay without Performance: Overview of the Issues, 2005, p. 8-15.
[23] Cf. Bebchuk, L. / Grinstein, Y.: The Growth of executive pay, 2005, p. 297.

current executive compensation as Bebchuk and Fried (2004) point out. Not only does this influence lead to compensation schemes that weaken manager's incentives to raise firm value, it even motivates actions which are reducing long-term firm value. Moreover, director behavior is also subject to an agency problem. Besides the various economic incentives directors have to protect arrangements that are pleasing to the firm's top-executives there are also various social and psychological factors like collegiality, team, spirit, adversity against conflicts, loyalty, cognitive dissonance etc. that lead to the same direction. Even though most directors hold stocks of their companies the positions are normally too small to give them a real financial incentive to fight the compensation practices sought by the management. Thus, the presumption that the board is seeking to increase shareholders wealth doesn't bear up. What's more this isn't limited to a small number of "bad apples" but widespread, persistent and systemic.[24] Bainbridge (2007) winds up their conclusion in saying that the problem is not the rapid growth of management wages, but instead the failure of producing compensation schemes that award high pay only for top performance.[25]

Bebchuk and Grinstein (2005) support evidence by examining the CEO compensation for U.S. based companies between 1993 and 2003. They find that CEO pay has increased much beyond the increase that could be explained by changes in firm size, performance and industry classification. Had the relationship between these variables and CEO pay stayed the same in 2003 than it was in 1993, mean CEO payment would only be about half the actual size.[26] Naturally, both of those studies are for the U.S. market but publicly traded companies in Switzerland and the USA are very similar in their structure and arrangements. Hofstetter (2002) explains that the Anglo-Saxon developments in the early nineties of the last century in corporate governance radiated into the other European countries and led amongst some country specific reports to the corporate governance principles of the OECD in 1999.[27] Given this undoubted leadership of the American development and since the adoption of the Cadbury-Report the corporate governance discussion in the United Kingdom as well have taken on issues regarding corporate governance it seems appropriate to refer to the Anglo-Saxon benchmarks when analyzing the Swiss practices.[28] In his assessment of today's Swiss

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[24] Cf. Bebchuk, L. / Fried, J.: Pay without Performance: Overview of the Issues, 2005, p. 8-15.
[25] Cf. Bainbridge, S.: Remarks on Say on Pay: An unjustified incursion on director authority, 2008, p. 2.
[26] Cf. Bebchuk, L. / Grinstein, Y.: The Growth of executive pay, 2005, p. 302.
[27] There are various definitions for Corporate Governance. For example the Cadbury-Report defines it as "Corporate governance is the system by which companies are directed and controlled."
Cf. Committee chaired by Cadbury, A.: The Financial Aspects of Corporate Governance, 1992, http://www.ecgi.org/codes/documents/cadbury.pdf, 03.01.2010 (Query).
[28] Cf. Hofstetter, K.: Corporate Governance in der Schweiz, 2002, http://www.six-exchange-regulation.com/download/admission/being_public/governance/cg_ch_de.pdf, 22.12.2009 (Query).

practices he also examines the discrepancies with the methods applied in the USA. Based on this the author concludes that even though there are differences sometimes far from being just subtleties it doesn't change the fact of the overall similarity of structure and arrangements. Thus, it is very probable that the developments outlined by Bebchuk and Fried (2004) and Bebchuk and Grinstein (2005) are analogous for Switzerland. Another point Bebchuk and Fried (2004) emphasize is that the problem is not that most executives and directors have acted less ethically than other would have in their place. The Problem lies within the system of arrangements and incentives within they operate.[29]

Bebchuk (2007) reflects that the existence of an advisory shareholder vote on the remuneration report, as an instrument to enhance shareholder voice, will alter the suboptimal conditions stated above in a way that is promotive to arms-length bargaining and as such result in pay-arrangements which are better serving shareholders interests.[30] More precisely, say-on-pay may make it easier for boards to overcome the social and psychological barriers mentioned above in bargaining with CEO's or other executives on behalf of shareholders.[31]

The second claim of Bainbridge (2008) is not necessary to prove for advocates of the Say-on-Pay Initiative in Switzerland as corporate law is always federal and never delegated to the cantons. The question in that sense would be if it was beneficial for Switzerland to give that power to the cantons and adopt the system of the USA where corporate law is business of the individual states but that is a different discussion altogether. This paper therefore focuses on the third part by trying to answer if say-on-pay is in fact an effective solution to the problem at hand i.e. will allowing shareholder votes on executive compensation create value.

The author performs three experiments. Firstly, to see how the market reaction was for the Swiss 'Say-on-Pay' legislation an event study is performed. With this method any significant positive or negative abnormal returns that appeared during a certain period can be measured. For this purpose the focus lies on the day the initiative committee announced it had gathered the needed 100'000 signatures.[32] Of course it has to be noted that even if abnormal returns are

[29] Cf. Bebchuk, L. / Fried, J.: Pay without Performance: Overview of the Issues, 2005, p. 9.
[30] Cf. Bebchuk, L.: Written Testimony Submitted Before the Committee on Financial Services United States House of Representatives Hearing on Empowering Shareholders on Executive Compensation, 2007, p. 4.
[31] Bebchuk, L. / Fried, J.: Pay without Performance: The Unfulfilled Promise of Executive Compensation, 2004, as cited in: Ferri, F. / Maber, D.: Say on Pay Vote and CEO Compensation: Evidence from the UK, 2009, p. 9.
[32] In Switzerland every citizen can demand a revision of the federal constitution if he or she can submit a petition signed by at least 100'000 eligible voters within 18 months. The referendum can be formulated as animation or as finalized text which can't be altered by either parliament or government. This is far more often the case and the Say-on-Pay initiative belongs to that category as well. Sometimes, the public authorities react on submitted initiatives with a less extensive counterproposal in the hope that it would rather be accepted by the public.
Cf. http://www.bk.admin.ch/themen/pore/vi/index.html?lang=de, 21.11.2009 (Query).

to be found the impact is likely to understate the economic significance of shareholder's say-on-pay because of the uncertainty of the vote's outcome.[33] Nonetheless, the author finds that there are in fact significant abnormal returns during the determined key event. In contrast to the results Cai and Walkling (2009) find in their analysis, the results for Switzerland indicate that the investors evaluate the initiative as negative. Secondly, it is examined whether a relationship exists between abnormal CEO compensation and abnormal returns during the event window. For this reason two models are constructed to measure abnormal CEO compensation. The results give evidence that for firms with underpaid CEO's the initiative could prove beneficial. Concerning the rest however, the market seems to value the initiative as disadvantageous especially for firms with modestly overpaid CEO's. This leaves room for the interpretation that for investors the biggest concern is if they have the right people as executives rather than if they earn too much. Thirdly, it is examined whether a relation exists between the abnormal returns found and good or bad corporate governance. For this reason five governance variables are determined for a well diversified subset of firms in the SPI® universe. The results indicate that firms which can be considered to have exemplary corporate governance structure – in case of the particular governance variable looked at – are the ones that got punished the most by the market in the three day event window. Furthermore, the firms with the weakest corporate governance are penalized the least indicating that the market values the initiative as less disadvantageous to them because an implementation of the initiative into the legislation would increase the transparency and give shareholders more access to the proxy.

The rest of this paper is structured as follows. In section II the possible hypotheses regarding the impact of the Say-on-Pay Initiative is discussed. Section III outlines the research design of the experiments along with characteristics of the different samples used. In section IV the empirical results are presented and their implications debated. Section V concludes.

[33] Cf. Cai, J. / Walkling, A.: Shareholders' Say on Pay: Does It Create Value?, 2009, p.4.

I. Background and Hypotheses

The author follows the lead of Cai and Walkling (2009) in this segment which state that the arguments regarding a say-on-pay legislation can be classified by three different hypotheses. These are namely the *interference*, *alignment* and *neutral effect* hypotheses.[34]

A look across the border reveals that the countries requiring a shareholder vote on executive compensation are Australia, the Netherlands, Norway, Sweden, and the United Kingdom. La Porta, Lopez-de-Silanes, and Shleifer (2006) argue investor protection to be the principal component of disclosure requirements, liability standards, and anti-director rights. For each of these variables they made indices for a large number of countries. Surprisingly, countries with a high shareholder protection (Australia, United Kingdom) are the ones which require just an adversary shareholder vote whereas the non Anglo-Saxon countries (The Netherlands, Norway and Sweden) established a binding shareholder vote.[35]

To illustrate how even advisory votes can have an impact not only on compensation design but also on composition of the board, Ferri and Maber (2009) describe how in 2003 the executive compensation report of GlaxoSmithKline (GSK) was rejected by an advisory shareholder vote. As a result the board of GSK consequently reduced executive severance pay and increased hurdles for option awards shortly after. Furthermore, the entire compensation committee was replaced the next year and an extensive and ongoing consultation with shareholders was put in place.[36]

It is important to note that in contrast to the Say-on-Pay Bill currently debated in the United States or the legislation introduced in the United Kingdom in 2002, the initiative in Switzerland doesn't demand an advisory vote but instead a *binding* one.

A. The interference hypothesis

The interference hypothesis declares that the Say-on-Pay Initiative will cause confusion.[37] Bainbridge (2008) argues that it decreases the board of directors' authoritative control which is the very mechanism that makes public corporations practicable in the first place. This comes from the fact that public corporations are too big in size to be controlled by a

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[34] Cf. Cai, J. / Walkling, A.: Shareholders' Say on Pay: Does It Create Value?, 2009, p. 7-10.
[35] Cf. Cai, J. / Walkling, A.: Shareholders' Say on Pay: Does It Create Value?, 2009, p. 8.
Cf. La La Porta, R. / Lopez-de-Silanes, F. / Shleifer, A.: What Works in Securities Laws?, 2006, p. 10.
[36] Cf. Ferri, F. / Maber, D.: Say on Pay Vote and CEO Compensation: Evidence from the UK, 2009, p. 1.
[37] Cf. Cai, J. / Walkling, A.: Shareholders' Say on Pay: Does It Create Value?, 2009, p. 7.

consensus-based decision-making process.[38] This aligns with Bebchuk (2007) who lists, amongst other things, that one could argue that democracy in a corporation should be purely representative - meaning that the only way shareholders can influence outcomes is through their choice of directors. Any other form of interference like second-guessing the directors' decisions could prove unfruitful. If the investors are not satisfied with the performance of a director they can simply replace him.[39]

Another claim of Bainbridge (2009) is that shareholders don't have the information required nor the incentives to make sound decisions on either operational or policy questions. Furthermore, he contemplates that a rational shareholder will expand the effort to make an educated and informed decision only if the gains surpass its costs. If one considers the complex and lengthy corporate disclosure documents, the opportunity cost entailed in getting informed is quite high and very apparent. This is why, in combination with the fact that most shareholders stock ownership is too small to have a significant impact on the vote's outcome, the shareholders are likely to value the benefits of a careful consideration as relatively low. This amounts to a conjecture that shareholders are rationally apathetic.[40]

Bainbridge (2009) also worries that the type of shareholders who are likely to make use of say-on-pay are driven by special interests which differ radically from those of ordinary investors. In the past these shareholders, who would get empowered by the initiative, have tended to come from an institutional background, for instance union and public employee funds. The more influence these unions or state pensions have the more pronounced the problem becomes.[41] Cai and Walkling (2009) reckon this fear could be warranted, as on average the sponsoring shareholder of company specific say-on-pay proposals in their sample holds less than 0.01% of the firm's outstanding shares. They also point out that the companies may not understand the reason for a low vote.[42] The board could face difficulties in identifying which part of the remuneration report is rejected or if the whole report does not match the investors' goodwill.

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[38] Cf. Bainbridge, S.: Remarks on Say on Pay: An unjustified incursion on director authority, 2008, p. 8f.
[39] Cf. Bebchuk, L.: Written Testimony Submitted Before the Committee on Financial Services United States House of Representatives Hearing on Empowering Shareholders on Executive Compensation, 2007, p. 8.
[40] Cf. Bainbridge, S.: Remarks on Say on Pay: An unjustified incursion on director authority, 2008, p. 9f.
[41] There are for example union funds in the U.S. which have used shareholder proposals to obtain employee benefits they couldn't get through bargaining. Additionally, public sector employee unions could use its pension funds as a vehicle for advancing political/social goals unrelated to shareholders interests generally.
Cf. Bainbridge, S.: Remarks on Say on Pay: An unjustified incursion on director authority, 2008, p. 10.
[42] Cf. Cai, J. / Walkling, A.: Shareholders' Say on Pay: Does It Create Value?, 2009, p. 8.

Another objection according to Bebchuk (2007) could be that many boards already seek to obtain shareholders' opinions on numerous matters including executive compensation design. These 'informal' communication channels as he calls it make a formal advisory vote unnecessary. Naturally, this argument isn't as strong for a *binding* shareholder vote as demanded by the initiative in Switzerland. More precisely, for a binding vote it conjuncts to the question of the requirement of a vote in general as the board already takes the shareholders opinion into account.[43]

H_1: The Say-on-Pay Initiative will reduce firm value

B. The alignment hypothesis

The alignment hypothesis suggests that the Say-on-Pay Initiative will better align the interest of shareholders and managers and improve governance and performance.[44] For every argument stated above there exists a counterargument which is supportive of the alignment hypothesis. These arguments have to be carefully weighted against each other in order to ascertain which hypothesis could turn out as being correct.

In response to the claim investors should limit themselves to electing directors Bebchuk (2007) writes that there exist considerable impediments to director replacement. Furthermore, it is perfectly possible that shareholders are content with an executives overall performance but view the boards' compensation decisions as inadequate. In such a case a vote on executive compensation would not only be desirable but useful as well.[45]

Even if shareholders aren't as well informed as directors regarding compensation design, Bebchuk (2007) notes that they might also have the strongest interest to act in a way what's best for them. Moreover, institutional investors are professional enough to know when they don't have the required information to judge about company specific matters which at least partly explains why some of them are paying courteous respect to the boards' judgment. As a result it can be expected that they only cast a "no" vote if they see good reasons to do so.[46]

[43] Cf. Bebchuk, L.: Written Testimony Submitted Before the Committee on Financial Services United States House of Representatives Hearing on Empowering Shareholders on Executive Compensation, 2007, p. 6.
[44] Cf. Cai, J. / Walkling, A.: Shareholders' Say on Pay: Does It Create Value?, 2009, p. 8.
[45] Cf. Bebchuk, L.: Written Testimony Submitted Before the Committee on Financial Services United States House of Representatives Hearing on Empowering Shareholders on Executive Compensation, 2007, p. 8.
[46] Cf. Bebchuk, L.: Written Testimony Submitted Before the Committee on Financial Services United States House of Representatives Hearing on Empowering Shareholders on Executive Compensation, 2007, p. 7.

Bebchuk (2007) also states that it shouldn't be forgotten that the outcome of say-on-pay votes relies predominantly on the opinions of the majority shareholders and not on those of minority shareholders with special interests. Furthermore, the concern that shareholders with special interests would threaten the board to extract concessions is completely off the mark in the case of a binding vote on compensation. As the initiative strives to get say-on-pay a mandatory rule for public companies there is no need for shareholder initiation and therefore it couldn't provide shareholders with any blackmailing power they could obtain by threatening the board to initiate votes that they would prefer not to have.[47] Practical evidence from Davis (2007) supports this in stating that few or no examples of shareholders with special interests appeared to succeed in hijacking advisory votes.[48]

Bebchuk (2007) counters the argument of the difficulty of interpreting a shareholder vote in saying that the board does most likely know the reason for shareholder dissatisfaction through informal communications with investors as well as the commentary of shareholder advisory firms. In addition, there is always the directors' own impression of how the firm's payment arrangements stand out and the shareholder vote would exactly provide them with the needed information if their feeling was right. Besides, getting a "noisy" signal from the investors is still more informative than not getting any signal at all.[49]

As Cai and Walkling (2009) conclude that firms with overpaid managers are most likely to benefit from an enactment as it gives the shareholders an opportunity to install adequate compensation.[50]

Always helpful for finalizing a hypothesis is practical evidence. Even though these testimonies come from advisory shareholder votes, it is very probable that they should stand true for binding shareholder votes as well. Davis (2007) reports that firms in the UK have cited numerous advantages since the annual advisory vote on the directors' remuneration report was established in 2002. He lists the following:

- "Dialogue with investors has improved in quality and quantity with "knock-on effects on other [non-compensation] issues."

[47] Cf. Bebchuk, L.: Written Testimony Submitted Before the Committee on Financial Services United States House of Representatives Hearing on Empowering Shareholders on Executive Compensation, 2007, p. 8.
[48] Cf. Davis, S.: Does 'Say On Pay' Work? Lessons on Making CEO Compensation Accountable, 2007, p. 28.
[49] Cf. Bebchuk, L.: Written Testimony Submitted Before the Committee on Financial Services United States House of Representatives Hearing on Empowering Shareholders on Executive Compensation, 2007, p. 5.
[50] Cf. Cai, J. / Walkling, A.: Shareholders' Say on Pay: Does It Create Value?, 2009, p. 9.

- Remuneration committee chairs are often grateful for opportunities to learn early of investor criticism on pay, as it provides them with leverage in fashioning performance-oriented packages.
- The “level of transparency and disclosure and explanation can’t be compared to the time before” advisory votes.
- Consultation has proven a “proactive, reputation building exercise” that can “draw the sting” from investor dissent.
- Compensation committees in general now meet more frequently, use more information, demonstrate more awareness that their work will be scrutinized; seek more independent outside advice; and show enhanced abilities to defend their decisions; and focus more on overall strategy.
- Boards have been able to continue to raise pay, including incentive pay, so long as it can be explained to shareowners as being linked to performance.”

He further discloses that the change in legislation proved a fillip to the boards and the downside was only a modest increase of cost in annual consultation and document preparation.[51]

Ferri and Maber (2009), who also examined the post say-on-pay climate in the UK, discovered no change in the level and growth rate of CEO pay after the adoption of the new legislation. They document, however, an increase in the sensitivity of CEO pay to poor performance. This effect is also most pronounced in firms that experienced a considerable voting opposition against their remuneration report. Interestingly, this increase in responsiveness of CEO pay to poor performance is also most pronounced in firms with an ‘excessive’ level of CEO pay before the enactment of say-on-pay, regardless of the voting outcome. As a conclusion firms must have responded to the threat of a negative vote by starting a consultatory dialogue with shareholders and changing pay practices in advance of the annual meeting to gain investors approval.[52] The consequences of an adverse voting outcome are mostly reputational. As Dyck and Zingales (2002) note “no insurance policy for managers or directors can protect them from such reputational penalties.”[53]

[51] Cf. Davis, S.: Does ‘Say On Pay’ Work? Lessons on Making CEO Compensation Accountable, 2007, p. 28.
[52] Cf. Ferri, F. / Maber, D.: Say on Pay Vote and CEO Compensation: Evidence from the UK, 2009, p. 2f.
[53] Cf. Dyck, A. / Zingales, L.: The right to tell: The Role of Mass Media in Economic Development, 2002, p. 109.

Baird and Stowasser (2002) declare that the say-on-pay legislation in the UK was established to increase accountability, transparency, and performance linkage of executive wages.[54] This is why Ferri and Maber (2009) conclude of their results that the say-on-pay legislation was effective in achieving at least one of its major goals, namely to strengthen the link between wages and realizations of poor performance at firms with debatable CEO compensation practices in an effort to reduce the rewards for failure.[55]

H_2: The Say-on-Pay Initiative will increase firm value

C. The neutral effect hypothesis

It can be argued that the Say-on-Pay Initiative won't have an impact on the market because even if it comes to a popular vote, the outcome will still remain ambiguous. As already explained it is unclear how the parliament will react and if there will be a counterproposal. The market may not value the gathering of the needed 100'000 signatures as an increase in probability that the legislation will change and the propositions of the initiative committee will ever become law. Hence, the neutral effect hypothesis indicates no significant market reaction to the Say-on-Pay Initiative.

H_3: The Say-on-Pay Initiative will not have an impact on firm value

[54] Cf. Baird, J. / Stowasser, P.: "Executive Compensation Disclosure Requirements: The German, UK and US Approaches", 2002, as cited in: Ferri, F. / Maber, D.: Say on Pay Vote and CEO Compensation: Evidence from the UK, 2009, p. 1.

[55] Cf. Ferri, F. / Maber, D.: Say on Pay Vote and CEO Compensation: Evidence from the UK, 2009, p. 4.

II. Research Design

According to Lamdin (2001) studies of regulatory changes have the inherent problem that there is not a condensed period of time over which the effect is measured but instead the legislative process can have a span of many months if not years. It is therefore difficult to identify event periods that were clearly unanticipated.[56]

To get a hold of the important legislative events of the Say-on-Pay Initiative a search on the website of the Federal Chancellery is executed.[57] To make sure a date isn't tested where confounding events distort the results and therefore lead to a wrong interpretation the financial headlines around the world are dissected. Table 9 in the appendix provides the chronology of the separate events of the Say-on-Pay Initiative. The first three events are very unlikely to have a significant, if any, impact on the market as they are solely related to the start up phase i.e. seeing whether the initiative complies with legal rights and collecting of the needed signatures. The next event, however, when it was known that the initiative committee had collected enough signatures for a popular vote was probably the one that really raised the awareness of the investors. The probability that it comes to a popular vote after this is usually very high and can thus be considered market relevant information. The events that follow are linked to the decision making process of parliament and government regarding how they want to deal with the initiative in the best possible way. Of course, the plausibility of an enactment of the regulatory change fluctuates with those events but there shouldn't be a significant jump in perceived probability. Therefore, the focus is placed on February 26th, 2008 - the day the signatures were submitted (hereinafter called key event).

In a first experiment the market reaction for every stock in the SPI® universe is observed.[58] In a second experiment two models of normal CEO compensation are constructed to calculate a measure for abnormal compensation. Next it is tested whether a relation exists between the abnormal CEO compensation of the 45 largest firms in Switzerland and the abnormal returns during the three day event window. In a third experiment it is examined if a connection exists between the stock market reaction and good or bad corporate governance.

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[56] Cf. Lamdin, D.: Implementing and interpreting event studies of regulatory changes, 2001, p.172.
[57] Cf. http://www.bk.admin.ch/themen/pore/vi/index.html?lang=de, 21.11.2009 (Query).
[58] Every stock means every stock that Thomson Reuters Datastream has available data from February 27th , 2007 to February 27th, 2008. Note that the composition of the stock is relatively volatile, meaning there are 25 firms that were in the index in the specified time frame that aren't included at the end of 2009. For these firms data isn't available because Datastream takes the actual composition and tries to find data for the specified time frame. Stocks that don't have data encompassing the whole time frame are left out to avoid any bias.

To assess an event's impact one needs a measure for abnormal return. According to Campbell, Lo and MacKinlay (1997) the abnormal return can be defined as the actual ex post return of the security over an event window minus the normal return over the same event window. The normal return is the return of the security that would be expected in the absence of the event. There are a few approaches available to calculate the normal return of a given security. They can be loosely grouped into the two categories statistical and economic. A common choice for the first category is the constant-mean return-model which assumes that the mean return of a given security is constant through time. Such models do not depend on economic arguments. In the second category assumptions about investor's behavior are taken into account in addition to statistical assumptions which give them a potential advantage over the first category. The market model, which represents a statistical model, is a potential improvement over the constant-mean-return-model because the variance of the abnormal return is reduced.[59]

The author uses the simple market model instead of the Fama-French-Carhart four factor model that Cai and Walkling (2009) use for two reasons. First of all it is difficult to obtain the needed data for Switzerland and secondly, as Bieri und Spremann (2009) found out, some of the added factors don't have an effect in Switzerland if recent data is used.[60]

Firstly the normal performance is estimated by running a separate regression for each company using the data within the estimation window. This regression can be modeled as with the following formula:

$$R_{s,t} - R_{f,t} = \alpha + \beta_1 \left(R_{m,t} - R_{f,t} \right) + e_t \qquad (1)$$

Where $R_{s,t}$ is the stock's return during period t, $R_{f,t}$ is the risk free rate and $R_{m,t}$ is the return of a representative market portfolio during period t. The estimation window spans from February 27th, 2007 to February 27th, 2008 and includes 247 trading days. As Table 1 in the appendix shows there was no other event period during that time which means there were not any confounding events that have to be excluded. With the saved regressions it is possible to predict the normal performance during the event window. Once this is done the daily abnormal return can be calculated by simply subtracting the computed predicted normal return from the actual return for each day in the event window. The cumulative abnormal return – in the literature often referred to as 'CAR' - represents the sum of the abnormal

[59] Cf. Campbell, J. / Lo, A. / MacKinlay, A.: The econometrics of financial markets, 1997, p. 151-155.
[60] Cf. Bieri, B. / Spremann, K.: Erklärt das Zyklusbeta Aktienrenditen?, 2009, http://www.alexandria.unisg.ch/EXPORT/DL/50243.pdf, 20.11.2009 (Query).

returns and is calculated for each company. [61] To test whether these CAR's are statistically significant the following test-statistic for each stock is computed:

$$test = \frac{1}{\sqrt{n}} \times \frac{CAR}{s} \qquad (2)$$

Where n is the sample size and s represents the sample standard deviation.

Since the length of the estimation window is at the discretion of the person who does the event study two robustness tests are performed. First the estimation window is moderately reduced from the original one year period which included 247 trading days to 180 trading days. After that it is aggressively reduced to 120 trading days.

As Cai and Walkling (2009) point out the abnormal returns may be correlated as all firms share the same event window. As result traditional event study methodology may understate the standard error which leads to a smaller T-statistic and therefore to a biased statistical inference.[62] Campbell, Lo and MacKinlay (1997) advice to create different portfolios by firm characteristics to diversify away the cross-sectional correlation between stocks.[63] Accordingly, the author forms portfolios for the second and third experiment by ranking the firms by abnormal CEO compensation and corporate governance variables. After that the portfolios cumulative abnormal returns are tested for significance.

To examine whether a CEO is overpaid or underpaid in relation to his colleagues a model of normal compensation is constructed. In the compensation literature it is often done by regressing the log of the CEO compensation with various other characteristics. The author uses the following regression:

$$LTCOM_i = \alpha + \beta_1 LMCAP_i + \beta_2(R_i - R_m) + \beta_3 AGE_i + \varepsilon_i \qquad (3)$$

Where $LTCOM_i$ is the natural log of the total compensation of the CEO of firm i, $LMCAP_i$ is the natural log of the market capitalization and R_i and R_m represent the annually stock and market returns respectively. For R_m the SPI® total return index is used. AGE_i stands for the CEO's age at the corresponding year-end. The residuals ε_i from the different regressions

[61] Cf. Cai, J. / Walkling, R.: Shareholders' Say on Pay: Does It Create Value?, 2009, p. 11.
The author uses a method described on the homepage of The Princeton University
Cf. http://dss.princeton.edu/usingdata/stata/analysis/eventstudy.html, 03.12.2009 (Query).
[62] Cf. Cai, J. / Walkling, A.: Shareholders' Say on Pay: Does It Create Value?, 2009, p. 11.
[63] Cf. Campbell, J. / Lo, A. / MacKinlay, A.: The econometrics of financial markets, 1997, p. 151-180.

represent unexplained or abnormal compensation. The natural log is used to normalize the distribution since compensation variables are highly skewed.[64]

The author also estimates a second model to account for differences in industries. The classifications were done according to Thomson Reuters Datastream. The precise specifications are:

$$LTCOM_i = \alpha + \beta_1 LMCAP_i + \beta_2 (R_i - R_m) + \beta_3 AGE_i + \sum_{j=1}^{n} \beta_{j+3} D_{ij} + \sum_{j=1}^{n} \beta_{j+n+3} D_{ij} LMCAP_i + \varepsilon_i \qquad (4)$$

The dummy variables D_{ij} correspond to the three biggest industries represented in the sample. They equal one when the firms industry is, respectively, industrials, financials and healthcare and zero otherwise. [65] The other industries where left out because the sample was short on an adequate amount of firms involved in them. The rest of the variables are the same as in equation (3).

Agrawal and Walkling (1994) explain the logic behind the chosen characteristics as follows. Executives of larger firms are paid more as empirical results show. This is why the market capitalization of equity is included as a measure of firm size. It is also very plausible that older executives have higher firm specific human capital which allows them to earn more money as they are more valuable to the firm. The market-adjusted return of the firm is included because firm performance is expected to be positively correlated with compensation.[66]

Using data from Kuipers, Schmid and Wagner (2009) the author forms a sample that consists of 45 firms that have data available for 2007.[67] Since the key event took place early in 2008 this is the latest data that was known to the investors. The average CEO total compensation is CHF 5’468’911 with an average of CHF 505’971 in stock option compensation. Naturally, shareholders shouldn’t be concerned with the level of the absolute compensation but rather

[64] Cf. Agrawal, A. / Walkling, R.: Executive Careers and Compensation Surrounding Takeover Bids, 1994, p. 990f.
[65] Cf. Agrawal, A. / Walkling, R.: Executive Careers and Compensation Surrounding Takeover Bids, 1994, p. 1010.
[66] Cf. Agrawal, A. / Walkling, R.: Executive Careers and Compensation Surrounding Takeover Bids, 1994, p. 1111.
[67] Cf. Kuipers, R. / Schmid, R. / Wagner, A.: PwC Executive Compensation & Corporate Governance 2009, 2009.

with the part of the compensation package that is unjustified by performance and the managerial labor market.[68]

Based on the individual abnormal compensation a ranking is made. After that the author forms 4 different portfolios and runs the following regression:

$$R_{p,t} - R_{f,t} = \alpha + \beta_1 (R_{m,t} - R_{f,t}) + \beta_2 D\_Event_t + e_t \quad (5)$$

Where $R_{p,t}$ represents the portfolio return at date t. D_Event_t is a dummy variable that equals one for the three trading days between February 25th and February 27th, 2008 and zero for any other date. The coefficient β_2 stands for the estimated average daily abnormal return during the Say-on-Pay event window and its T-statistic provides the statistical significance of the abnormal return. The rest is the same as in the first equation. Note that the dependant variable is now the average daily stock return of the firms in a portfolio.[69]

The procedure for the third experiment is exactly the same as for the second experiment. The only difference is that the portfolios are sorted after corporate governance variables the author collected from annual reports of the financial year 2007. These variables are: percent of outside directors, percent of busy outside directors, percent of outside directors appointed by CEO, outside directors' stock holdings and the board size.[70] For the first four variables the sample includes 100 randomly picked firms from the SPI® universe with every industry having representatives as well as including all different sizes of firms from small to mid to large cap corporations. For the fifth variable the sample is expanded to all firms which were in the sample of experiment one to find out how many directors were serving on the board at the time of the key event. Adjustments were made where necessary.[71]

[68] Cf. Cai, J. / Walkling, A.: Shareholders' Say on Pay: Does It Create Value?, 2009, p. 12.
[69] Cf. Cai, J. / Walkling, A.: Shareholders' Say on Pay: Does It Create Value?, 2009, p. 11-34.
[70] The definitions for these variables can be found in the Appendix.
[71] To avoid bias the sample had to be reduced on two occasions by three firms which had no outside directors at all. This was done for the variables 'percent of busy outside directors' and 'percent of outside directors appointed by CEO'. Additionally, the board size couldn't be found for two firms.

III. Empirical Results

A. **Market reaction to the Say-on-Pay Initiative**

In a first experiment the market reaction for 208 stocks in the SPI® universe is observed. As explained in section two a model of normal return is constructed and then used to predict the return of every single stock if the event didn't happen. After that the abnormal return is computed by simply subtracting the predicted return from the actual return. The individual abnormal returns are then tested for significance. The author found that 56 of 208 firms had significant abnormal returns occurring in the event window with only two of them being part of the Swiss Market Index SMI®. As table 1 shows the shares of industries which had the biggest significant abnormal returns are the ones of firms being in the technology and industrial sector (oil & gas has just one observation and is therefore not meaningful) while shares in the financial sector did not show any exceptional losses. This correlates with the expectance that the financial crisis gradually migrated into the real economy in early 2008. This is also shown by the average beta of the different economies. Both technology and the industrial sector have the highest average beta (besides oil & gas) which means that they are expected to be hit exceptionally hard if the economy as a whole is in misery.

Table 1: Significant Abnormal Returns by Industry

Industry	Number of corporations	Avg. Cumulative Abnormal Return	Avg. Market Capitalization (in Mio. CHF)	Avg. Beta
Oil & Gas	1	-0.07	1'609	1.570
Basic Materials	1	-0.02	27'396	0.437
Industrials	15	-0.05	611	1.199
Consumer Goods	6	-0.02	1'073	0.462
Healthcare	5	-0.04	5'110	0.915
Consumer Services	4	-0.03	1'008	0.810
Telecommunications	0	-	-	-
Utilities	3	-0.03	1'577	0.558
Financials	18	-0.03	1'242	0.724
Technology	3	-0.07	125	1.132

Source: Own illustration

Please note that only four firms have a significant *positive* abnormal return during the event window while the rest reported negative ones. Interestingly, two of them are organized as holdings with majority shareholders of 60.54 % and 54.57% ownership of total equity capital and voting rights respectively. The other two consist of an affiliated company which is controlled with 59.49% by the parent company and one that is controlled by four big shareholders with one of them having a voting right of 58,24%.

By looking at figure 1 it becomes clear why the average of the cumulative returns is negative (-0.0155%). The returns during the estimation window were very high in comparison to the ones in the event window. As explained in section II the market model used these returns to predict the normal returns during the event window. Naturally these estimations where then higher than the actual returns which resulted in negative figures for abnormal returns. To verify that the cumulative abnormal returns were not due to an unfortunate placement and length of the estimation window a robustness test is performed. Results for this are on page 26.

Figure 1: Chart for the SPI® total return index from February 27th, 2007 to February 27th, 2008

Source: Six Swiss Exchange

The first and most simple explanation could be that the neutral effect hypothesis is true. Maybe the market didn't perceive the submitted 100'000 signatures as an increase in probability that say-on-pay would get introduced into law. This would require that the abnormal returns the event study disclosed during the time between February 25th and February 27th, 2008 are due to another event and not from an association with the key event. However, as table 9 in the appendix shows no confounding event was found. This means the likelihood of the neutral effect hypothesis being true is considerably weakened.

Shleifer and Vishny (1997) point out that large minority shareholders need alliances with other investors to exercise control. As a result the power of managers to interfere in these alliances is greatly enhanced in comparison to majority shareholders. Intuitively, one could argue that such companies would get rewarded by the market because it takes away some of the managers proxy and gives shareholders more power. But this isn't the case with the four last mentioned firms as they are being ruled by large shareholders exercising their voting rights. The initiative is meaningless to them as they would dictate the votes on management compensation. Once they voice their opinion a vote count becomes redundant.[72] Based on this one could conclude that the market as a whole doesn't treat the Say-on-Pay Initiative as an improvement over the existing legislation. Moreover, since 52 of the 56 significant CAR's are negative the market sees the initiative as harmful in general and only firms with a majority shareholder are not punished because a vote is meaningless to them.

Unfortunately, this analysis doesn't hold up. According to the KPMG comment on the 'Swiss Code of Best Practice for Corporate Governance' over two-third of the public companies listed in Switzerland are dominated by major or majority stockholders.[73] The explanation above would only make sense for markets where real publicly owned firms exist, such as in the Anglo-Saxon countries. Consequently, there must be another explanation.

Following Finkelstein and Hambrick (1989) the board is more likely to meet its vigilance role when it is composed of individuals who themselves hold a significant personal stake in the firm's actions. Such a situation could happen if the board's outside directors are major shareholders or paid representatives of major shareholders. They state that under these conditions the board can be expected to exert tighter control over the CEO. These board members would have incentives to exercise authoritative influence over executive compensation and link it to the firm's performance. This gratification system would reward high performance and penalize low performance in an attempt of maximizing shareholders wealth by inducing adequate managerial actions.[74] Bebchuk and Fried (2004) write: "As long as corporate directors are believed to carry out their tasks for the benefit of the shareholders,

[72] Cf. Shleifer, A. / Vishny R.: A Survey of Corporate Governance, 1997, p. 755.
[73] Cf. KPMG's Audit Committee Institute: KPMG Kommentar zum Swiss Code, 2002, http://www.auditcommittee.ch/de/17951_18048.htm, 02.01.2010 (Query).
[74] Cf. Finkelstein, S. / Hambrick, D.: Chief Executive Compensation: A Study of The Intersection of Markets and Political Processes, 1989, p. 125.

current governance arrangements – which insulate boards from intervention by shareholders – appear acceptable."[75]

Certainly this sheds a new light on the results of the analysis. When looking at the four firms with a significant *positive* abnormal return mentioned above one finds that in three of those cases, the majority shareholder is at the same time the chairmen of the board. In the other case it seems that no association exists between the board and the controlling parent company. In combination with the above statements from Finkelstein and Hambrick (1989) and Bebchuk and Fried (2004) the author concludes that the compensation practices of these firms are expected to be efficient already. This means a vote becomes meaningless in two ways. Firstly, a vote is meaningless with a majority shareholder because only his opinion counts. Secondly, in the case where the board partly consists of majority shareholders it can be assumed that they design compensation packages in the best interest of all shareholders. If the market values the Say-on-Pay Initiative as potentially harmful it seems plausible that firms which wouldn't be affected by it benefit the most. This is exactly what was found.

What about the other firm whose parent company (the majority shareholder) isn't sitting in the corporate board? As Davis (2007) states institutional investors in the UK assert that if they can take the responsibility of picking, choosing and holding equities, they can handle the task of evaluating whether compensation policies are structured in a way that takes into consideration their interests.[76] Of course there remains a question mark whether they do so but the assumption is that institutional investors regardless of nationality perform this evaluation and if necessary use their power to change the compensation packages in a way that addresses their interests. Hofstetter (2002) writes in this context that Swiss firms are facing more institutional stockholders which are willing to use their power these days than it was the case a few years ago. This doesn't change the fact however, that shareholder activism is always associated with additional costs and the propensity for passive investment strategies remains strong.[77] A prominent reason for this is the 'free-rider' effect. The costs for being active accrues fully by the particular investor but the rewards arising from it are beneficial to all other shareholders as well. Another reason could be that incentive structures within the internal organization of institutional investors may also help to ensure that their

[75] Cf. Bebchuk, L. / Fried, J.: Pay without Performance: The Unfulfilled Promise of Executive Compensation, 2004, p. 9.
[76] Cf. Davis, S.: Does 'Say On Pay' Work? Lessons on Making CEO Compensation Accountable, 2007, p. 24.
[77] Cf. Hofstetter, K.: Corporate Governance in der Schweiz, 2002, http://www.six-exchange-regulation.com/download/admission/being_public/governance/cg_ch_de.pdf, 22.12.2009 (Query).

representatives feel little inclination to actively promote long-term shareholder interests because their financial remuneration relies solely on short-term targets.[78]

In addition it could be shown that if the cumulative abnormal returns across all firms are treated as a group they are indeed significant during the event window. The T-statistic equals -5.88 which is significant at the 1% level.[79] This means the date the author has identified as key event has in fact had an impact on the investor's decisions in the market. Therefore, these results provide support for the interference hypothesis. If the abnormal returns are tested with an altered version of the regression in equation (5) where $R_{p,t}$ is replaced with the individual stock return $R_{s,t}$ the results are almost identical.[80]

Taken together the results are consistent with the interference hypothesis.

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[78] Cf. Hofstetter, K.: Corporate Governance in der Schweiz, 2002, http://www.six-exchange-regulation.com/download/admission/being_public/governance/cg_ch_de.pdf, 22.12.2009 (Query).

[79] In stata if the command regress is run without covariates it is the equivalent to a t-test. Thank goes to Martin Weiss of the statalist mailserver for kindly pointing this out.
The p-value of the constant will give the significance of the cumulative abnormal returns across all companies. Cf. http://dss.princeton.edu/usingdata/stata/analysis/eventstudy.html, 03.12.2009.

[80] For the dummy variable D_Event_t a coefficient of -0.00517 is estimated with a corresponding T-statistic of -6.00 which is also significant at the 1% level.

Robustness test

As explained earlier the negative abnormal returns could result from an unluckily placed estimation window, for this reason two robustness tests are performed. In the first the estimation window is moderately reduced from the original one year period which includes 247 trading days to 180 trading days. The author finds that 54 of 207 firms have significant abnormal returns occurring in the event window with the same two firms from the SMI® as before. This time, however, seven firms report significant *positive* abnormal returns and the T-statistics are a little more volatile. Five of them are organized as holdings with three of them having a majority shareholder and two having a major shareholder with fewer than 30% of equity. The non-holdings being the ones mentioned before with majority shareholders of 59.49 % and 58.24% respectively. More importantly, in five of those seven firms the major shareholders are members of the board of directors or have board representation. Again, it seems like the firms which won't be affected by a possible enactment of say-on-pay and the ones who already have an efficient compensation system benefit the most.

In the second robustness test the estimation window is aggressively reduced to 120 trading days. With this setting, 51 of 208 firms report significant abnormal returns. The group of corporations with positive ones consists of the same companies as before except that two holdings fell out. In this scenario, the majority shareholders are represented in three of the five boards of directors.

In each of these tests the cumulative abnormal returns are significant at the 1% level when treated as a group with a T-statistic of -5.26 and -5.14 respectively.

B. Market reaction to the Say-on-Pay Initiative by abnormal compensation

In the second experiment the firms are sorted into four different portfolios based on their quartile ranking of abnormal CEO compensation in the fiscal year of 2007. This is done by constructing a model of normal compensation. Figure 2 presents the software output of the sample after using model 1 in equation (3).

Figure 2: Software output for model 1

```
      Source |       SS       df       MS              Number of obs =      45
-------------+------------------------------           F(  3,    41) =   17.70
       Model |  17.1568428     3  5.71894759           Prob > F      =  0.0000
    Residual |  13.2504416    41  .323181503           R-squared     =  0.5642
-------------+------------------------------           Adj R-squared =  0.5323
       Total |  30.4072844    44  .691074645           Root MSE      =  .56849

------------------------------------------------------------------------------
 t_total_log |      Coef.   Std. Err.      t    P>|t|     [95% Conf. Interval]
-------------+----------------------------------------------------------------
market_cap~g |   .4952288   .0694268     7.13   0.000     .3550185    .6354392
excess_ret~n |   .8151559   .4085351     2.00   0.053    -.0098975    1.640209
         age |   .0024371   .0103233     0.24   0.815    -.0184111    .0232853
       _cons |   3.710412   1.616674     2.30   0.027     .4454732     6.97535
------------------------------------------------------------------------------
```

Source: Stata output

The results indicate that the firm size – measured by the market capitalization – is significantly related to the CEO total compensation at the 1% level. Additionally the coefficient is positive which suggests the relationship to be positive as well. Furthermore the market-adjusted return of the firm is significant at the 10% level whereas the CEO's age doesn't seem to have a relation with his remuneration.

However, the objective isn't to test whether the coefficients are significant or not. The objective is to make an adequate model of compensation. This is why model 1 is enhanced with dummy variables and interaction terms to take different industries into consideration by letting the intercept and slope vary.[81] Consequently, the same regression is made with model 2. As can be seen by looking at figure 3 the adjusted R-squared is 0.5757 and therefore slightly higher than 0.5323 in model 1. The author embedded three dummy variables and interaction terms for the three biggest industries that occurred in the sample.[82] Obviously it would have been possible to push the adjusted R-squared even higher by creating more

[81] Cf. Agrawal, A. / Walkling, R.: Executive Careers and Compensation Surrounding Takeover Bids, 1994, p. 1012.
[82] As the firm size is the only significant variable in model 1 the author embedded interaction terms for the market capitalization to take the different industries into account.

dummy variables but in regard to the number of observations the other industries have that wouldn't be reasonable.[83]

Figure 3: Software output for model 2

```
      Source |       SS       df       MS              Number of obs =      45
-------------+------------------------------           F(  9,    35) =    7.63
       Model |  20.1443061     9  2.23825624           Prob > F      =  0.0000
    Residual |  10.2629783    35   .29322795           R-squared     =  0.6625
-------------+------------------------------           Adj R-squared =  0.5757
       Total |  30.4072844    44  .691074645           Root MSE      =  .54151

------------------------------------------------------------------------------
 t_total_log |      Coef.   Std. Err.      t    P>|t|     [95% Conf. Interval]
-------------+----------------------------------------------------------------
market_cap~g |    .335593   .1354867     2.48   0.018     .0605404    .6106456
excess_ret~n |   1.147859   .4155761     2.76   0.009     .3041948    1.991523
         age |   .0056109   .0104214     0.54   0.594    -.0155456    .0267675
d1_industr~s |   2.182785   4.744655     0.46   0.648    -7.449377    11.81495
d2_financi~s |   -8.43095   4.276441    -1.97   0.057    -17.11259    .2506866
d3_healthc~e |  -3.641257   4.260638    -0.85   0.399    -12.29081    5.008297
          i1 |  -.0991517      .2071    -0.48   0.635    -.5195871    .3212836
          i2 |   .3748357    .184113     2.04   0.049     .0010664    .7486051
          i3 |   .1722168   .1833091     0.94   0.354    -.1999204    .5443541
       _cons |   7.068183   3.139666     2.25   0.031     .6943219    13.44204
------------------------------------------------------------------------------
```

Source: Stata output

With this enhanced model the market capitalization is yet again significant although this time at the 5% level. Interestingly, the market-adjusted return has a T-statistic of 2.76 which makes it significant at the 1% level. As both coefficients are positive one can conclude that the two variables are positively related to CEO compensation. Again, the CEO's age doesn't seem to have an effect on his remuneration. The T-statistics of the industry dummy variables test for differences between the industrial, financial and healthcare sector and the base group which contains the rest.[84] The interaction terms provide the deviation between the coefficients of $LMCAP_i$ between the particular industries and the base group. The T-statistic of the financial sector interaction term is significant at the 5% level which means we can assume –although with caution – that the market capitalization in the financial sector has a bigger influence on the CEO payment that in the base group.

Next the firms of the sample are put into four different portfolios based on their quartile ranking of abnormal compensation. After that the market model in equation (5) is used to estimate the abnormal returns of the portfolios during the event window. If the Say-on-Pay Initiative was beneficial for a firm then the market should react positively to the prospect of it

[83] With five dummy variables it would take the R-squared to 0.7115 and the adjusted R-squared to 0.5905. However, the author's opinion is that letting the slope and intercept vary for industries with 5 or less observations (in the sample) isn't practical.
[84] For a complete list of all classifications used by Datastream please see table 1.

becoming law. Therefore firms with inefficient compensation contracts or firms who are overly generous with their executive's pay would benefit the most by the Say-on-Pay Initiative (i.e. have the highest cumulative abnormal return) as it gives the investors more access to the proxy. But the initiative may not benefit all firms. For companies which already have an efficient compensation design the initiative may do more harm than anything else. In these cases there could be a negative impact on the stock price or no impact at all. Table 2 shows the results for the analysis.

Table 2: Market reaction to Say-on-Pay Initiative by abnormal CEO compensation using model 1

Abnormal CEO total compensation Ranking	Number of corporations	Abnormal Compensation (in Mio. CHF)	Portfolio CAR (%)	T-statistic	P>|t|	% positive
1 Lowest	12	-3.676	0.0031	0.3	0.763	50.00
2	11	-1.095	-0.0022	-0.22	0.824	45.45
3	11	0.625	-0.0170	-2.06	0.041	27.27
4 Highest	11	4.481	-0.0050	-0.44	0.661	54.55

Source: Own illustration

If this logic was applied to the experiment then the Portfolio CAR's should steadily increase from the lowest quartile to the highest. As can be seen by table 2 this is not what was found. Strangely, it is the other way around for the first three quartiles with the abnormal return gradually *decreasing* until the third quartile which is at the same time the only one with a significant abnormal return, that is -0.02% over the three day event window. Yet for firms with the highest abnormal compensation the abnormal portfolio return equals an insignificant -0.01.

Cai and Walkling (2009) verify that the return patterns are not driven by outliners by calculating the fraction of the stocks in a portfolio that have positive abnormal returns.[85] The author does the same but uses the method presented in experiment one instead of the Fama-French four-factor model to calculate the individual stock abnormal returns. As can be seen by table 2 this statistic follows a similar pattern as the portfolio CAR's with the third quartile having the lowest % positive.

[85] Cf. Cai, J. / Walkling, A.: Shareholders' Say on Pay: Does It Create Value?, 2009, p. 15.

Taken together this leaves room for the following interpretation. The market reaction implies that for firms with underpaid CEO's the initiative could prove beneficial. Since the firm doesn't pay enough in comparison to its peers it could be that not the best fitting and adequately qualified executive was hired. For the rest however, the market seems to value the initiative as disadvantageous especially for firms with modestly overpaid CEO's. It seems that for investors the biggest concern is if they have the right people as executives rather than if they earn too much. Thus, this result is consistent with the interference hypothesis.

As the first model had almost the opposite results as the expectations a look should be taken at the second model which is essentially an enhancement of the first as it permits slope and intercept to vary by industry. Using this model the 45 firms were almost evenly split in one half having negative and the other half having positive abnormal CEO compensation. A look at table 3 reveals that the results again don't follow the conjecture.

Table 3: Market reaction to Say-on-Pay Initiative by abnormal CEO compensation using model 2

Abnormal CEO total compensation Ranking	Number of corporations	Abnormal Compensation (in Mio. CHF)	Portfolio CAR (%)	T-statistic	P>|t|	% Positive
1 Lowest	12	-3.702	-0.0015	-0.16	0.877	25.00
2	11	-0.362	-0.0130	-1.34	0.182	45.45
3	11	1.724	0.0018	0.22	0.824	72.73
4 Highest	11	2.677	-0.0094	-0.86	0.388	36.36

Source: Own illustration

This time the third quartile is the only portfolio with a positive portfolio CAR while the rest has a negative one. The pattern of the CAR's and the positive stock returns seem to be both random. Additionally, none of the four portfolios have significant abnormal returns even at the 10% level. Therefore, in the author's opinion, it is needless to speculate why the results came out as they did.

The author cautions that it shouldn't be forgotten that the sample of the second experiment is very small (n=45) and as a result lies under the statistical rule of having at least 50 observations. Of course this shouldn't be enough reason to disqualify the qualitative statements. Far more important is that the sample consists of the biggest corporations in Switzerland which means middle or small cap firms aren't covered. Thus it could very well be true that if one includes those in the sample the results could be different altogether and there could be a different relationship between CEO compensation and the market reaction on the day the author has identified as key event.

In the second part Cai and Walkling (2009) were paraphrased in saying that shareholders shouldn't be concerned with the level of absolute compensation but rather with the fraction of the compensation that is unjustified by performance and the labor market for managers.[86] Following their example the author expands the analysis to test if the abnormal compensation measure calculated by the two models above are a proxy for total compensation and to examine whether the market differentiates between the level of compensation or the level of abnormal compensation.[87] For this reason a look is taken at the highest quartile of total compensation in the already familiar sample of the 45 largest firms in Switzerland. Specifically, the firms with a negative abnormal compensation are of interest. The executives of these firms may have a high level of absolute payment but according to the compensation models they are actually underpaid relative to their peers. Thus, the firms for which model 1 identified a negative abnormal compensation are examined. A look at the market reaction reveals that the firms of these executives have an insignificant abnormal return of -0.01% during the three day event window, which is 1.56% higher than the rest of the sample. This concludes that the market sees the initiative as less harmful for firms with highly paid, but not overpaid CEO's. Moreover, it shows that the market differentiates between overpaid and highly paid which justifies the use of abnormal compensation measures in this work. The results collected by using model 2 are very similar and qualitatively the same.

Evidence from the United Kingdom by Ferri and Maber (2009) also suggests that the market differs between raw absolute compensation and abnormal compensation once say-on-pay is introduced in the legislation. They report that shareholders did not use the power of the say-on-pay vote to indiscriminately attack large CEO pack packages, but rather to pressure corporations with levels of CEO pay larger than justified by economic factors.[88]

It is important to point out that the cumulative abnormal returns are not a capitalized value of compensation reduction or destroyed value due to worse compensation designs. This is due to the fact that the probabilities of possible events are incorporated in the stock price. Suppose the market viewed the happenings on February 27th, 2008 as an increase in probability of 50% that a binding say-on-pay vote would be introduced into law. For the firms in the lowest

[86] Cf. Cai, J. / Walkling, A.: Shareholders' Say on Pay: Does It Create Value?, 2009, p.12.
[87] Cf. Cai, J. / Walkling, A.: Shareholders' Say on Pay: Does It Create Value?, 2009, p.16.
[88] Cf. Ferri, F. / Maber, D.: Say on Pay Vote and CEO Compensation: Evidence from the UK, 2009, p. 3.

abnormal compensation quartile there was an abnormal return of 0.0031% in model 1. The average market capitalization of these companies is 13.387 billion CHF. This means the average value creation, should the initiative get enacted, is about CHF 42 million (0.0031% × 1313.387 billion ÷ 50%). However, average annual abnormal compensation is -3.7 million.[89] The market seems to be of the opinion that the additional costs arising to level the payment of these executives to their peers carries a much bigger gain which by far outweigh these costs. The distortion of incentives through managerial influence could well prove to be a larger burden to shareholders regarding costs than excessive compensation per se as Bebchuk and Fried (2004) conclude. They make the case that when managers' are granted the liberty of unloading corporate shares and options basically at their own will and they expect to do this in the near future they have incentives to massage figures or suppress bad news in order to mislead the market. Whatever risk-bearing or liquidity benefits are obtained cannot possibly be offset by the efficiency costs such distortions may produce.[90] Therefore, the initiative is believed to do more than just impose adequate compensations for the board of directors and the management. Mehran (1995) found that improving CEO's incentives through adequate compensation can lead to improved firm performance.[91]

[89] In the style of Cai, J. / Walkling, R.: Shareholders' Say on Pay: Does It Create Value?, 2009, p.17.
[90] Cf. Bebchuk, L. / Fried, J.: Pay without Performance: Overview of the Issues, 2005, p. 11.
[91] Cf. Mehran, H.: Executive compensation structure, ownership, and firm performance, 1995, p. 179f.

C. Market reaction to the Say-on-Pay Initiative by corporate governance

The impact the Say-on-Pay Initiative has on each firm is likely to be influenced by firm specific characteristics.[92] As the major context of the initiative is corporate governance the author again follows the guidance of Cai and Walkling (2009) in this segment to examine whether firms with good or firms with bad corporate governance benefit the most by the initiative.[93] As the first experiment showed the overall market didn't react positively on the increased probability of the initiative being enacted. In that case, this test should make the picture clearer for which firms the investors view the initiative as less harmful.

Firstly, the author sorts the portfolios into four portfolios based on a set of different corporate governance variables he conducted from annual reports of the financial year 2007. Because the distribution of some variables is discrete, the four portfolios can have a different number of firms allocated to them. Secondly, by using the market model described in equation (5) the abnormal portfolio returns are estimated. This will give an insight as to whether a relation exists between the market reaction and the particular governance characteristic or not. For the first four variables the sample includes 100 randomly picked firms from the SPI® universe with every industry having representatives as well as including all different sizes of firms from small to mid to large cap corporations.

The first variable tested is *percent of outside directors on the board*. Fama and Jensen (1983) believe that outside directors are experts in decision control and therefore add value by monitoring the management as well as by acting as arbiters between internal managers. Furthermore, their complementary knowledge proves to be a valuable asset in dealing with specialized decision problems.[94] Empirical evidence by Rosenstein and Wyatt (1990) finds a positive stock price reaction to the election of outside directors.[95] In addition, Weisbach (1988) reports that for a firm with poor performance the probability of a CEO replacement is higher when the board is dominated by outside directors.[96] In a newer study Fich and Shivdasan (2006) find similar evidence. The probability of a (forced) CEO turnover when the

[92] Cf. Cai, J. / Walkling, R.: Shareholders' Say on Pay: Does It Create Value?, 2009, p. 17f.
[93] Cf. Cai, J. / Walkling, R.: Shareholders' Say on Pay: Does It Create Value?, 2009, p. 10-20.
[94] Cf. Fama, E. / Jensen, M.: Separation of Ownership and Control, 1983, p. 314f.
[95] Cf. Rosenstein, S. / Wyatt, J.: Outside directors, board independence, and shareholder wealth, 1990, as cited in: Rosenstein, S. / Wyatt, J.: Inside directors, board effectiveness, and shareholder wealth, 1997, p. 230.
[96] Cf. Weisbach, M.: Outside Directors and CEO Turnover, 1988, p. 438-447.

firm experiences a 50% decline in industry-adjusted performance is almost 7% higher if the board consists mostly of outside directors which aren't classified as busy.[97]

Table 4: Market reaction to Say-on-Pay Initiative by percent of outside directors on the board

	Number of corporations	Mean percent of outside directors on the board	Portfolio CAR (%)	T-statistic	P>|t|	Positive
1 Lowest	28	0.395	-0.0218	-2.26	0.025	25.0%
2	22	0.633	-0.0109	-1.01	0.314	50.0%
3	27	0.813	-0.0161	-1.75	0.081	37.0%
4 Highest	23	0.969	-0.0023	-0.34	0.733	52.2%

Source: Own illustration

Table 4 shows the results of the analysis when the portfolios are sorted by percent of outside directors serving on the board of directors. Interestingly, the first quartile reports the highest cumulative abnormal return over the three day event window with -0.02%. This is also the only figure which is significant at the 5% level. Besides this, the first quartile is also the one with the lowest percent of firms with positive abnormal individual stock returns. The fact that all quartiles are having a negative portfolio CAR in addition with the evidence provided in stage one permits only one conclusion. The market seems to evaluate the initiative as being the most disadvantageous for firms in the lowest quartile. Moreover it needs to be mentioned that the portfolio CAR of the third quartile is significant at the 10% level.

Rosenstein and Wyatt (1990) find that under certain circumstances an appointment of a new inside director can be more valuable to a firm when the board is numerically dominated by outside directors. This move towards a more balanced board is beneficial if there is moderate inside ownership which aligns the interests of managers and outside shareholders.[98] Langevoort (2000) summarizes that while the corporate governance literature has moved towards the modern dogma that boards should be independent, skeptic and rigorously loyal to shareholder interests the empirical evidence of the superiority of boards which consist largely of only independent outside directors by finding a relation between variables of board independence and the profitability of a firm or its stock price has been missing. He reasons that while the term 'independent' is very subjective and because of that said relation hasn't

[97] Cf. Fich, E. / Shivdasan, A.: Are Busy Boards Effective Monitors?, 2006, p. 722.
All papers mentioned in this study define a busy director as someone that holds three or more board seats.
[98] Cf. Rosenstein, S. / Wyatt, J.: Inside directors, board effectiveness, and shareholder wealth, 1997, p. 240.

been found yet it could be that the absence of this correlation is due to the fact that boards are most effective when inside and outside directors work cooperatively.[99] Bhagat and Black (1999) also speculate that the reason for this absence could be due to the fact that "an optimal board contains a mix of inside, independent, and affiliated outside directors, who bring different skills and knowledge to the board".[100] Beysinger and Hoskisson (1990) believe that depending on the industry a different board composition should be applied to enhance the organizational effectiveness.[101]

Correspondingly with the evidence from the literature above the author concludes that the first quartile is the one with the highest abnormal return because the boards of these firms are the most balanced in their composition and due to that their practices regarding compensation design are already efficient making an additional consulting of shareholders superfluous.

The next variable is *percent of busy outside directors*. The idea behind this is simple. The more board memberships and other mandates a person has the less time can be spent on each function. Fich and Shivdasan (2006) find in their study for the U.S. market that firms where the majority of directors serve on three or more boards are associated with weak corporate value and governance. They display a significant lower market-to-book ratio, lower firm profitability and lower sensitivity of CEO turnover to weak performance. As a consequence they conclude that firms that excessively assign directors who already have numerous other board seats are likely experience a drop in corporate governance quality.[102]

Table 5: Market reaction to Say-on-Pay Initiative by percent of busy outside directors

	Number of corporations	Mean percent of busy outside directors	Portfolio CAR (%)	T-statistic	P>|t|	Positive
1 Lowest	35	35.1%	-0.0219	-2.49	0.013	34.3%
2	14	58.8%	-0.0043	-0.51	0.611	50.0%
3	27	70.9%	-0.0131	-1.47	0.142	44.4%
4 Highest	21	93.6%	-0.0043	-0.44	0.659	38.1%

Source: Own illustration

[99] Cf. Langevoort, D.: The Human Nature of Corporate Boards: Law, Norms and the Unintended Consequences of Independence and Accountability, 2000, p. 1-4.
[100] Cf. Bhagat, S. / Black, B.: The Uncertain Relationship Between Board Composition and Firm Performance, 1999, p. 39.
[101] Cf. Baysinger, B. / Hoskisson, R.: The Composition of Boards of Directors and Strategic Control: Effects on Corporate Strategy, 1990, p. 84.
[102] Cf. Fich, E. / Shivdasan, A.: Are Busy Boards Effective Monitors?, 2006, p. 721f.

Table 5 shows that there is no real return pattern identifiable and with the exception of the first quartile all portfolio CAR's had figures which are not even significant at the 10% level. It is worth noting that firms which appointed outside directors that have the least additional mandates outside said firms are punished the most by the market. Following Fich and Shivdasan (2006) it can be argued that these firms have good corporate governance with the majority of outside directors being able to pursue their monitoring duty. For these firms the initiative just proves to be further costs without adding sufficient benefits to offset the expenses.

Another variable examined is the *percent of outside directors appointed by CEO.* This accounts for the fact that the most influential members on the board are internal directors which can use their authority to nominate the outside board members they prefer (Fama and Jensen, 1983).[103] If the interests of these managers are not aligned with the shareholders they may not select the outside directors best suited for the job but the ones who are more convenient for them. Bhagat and Black (1999) also raise concerns over the independence of some outside directors. They point out that while outside directors may be considered as independent by common definitions they could very well be influenced in subtle ways clouding their judgment. For instance, the outside director could work for a company or is employed by a university or a foundation which receives donations from the corporation. A personal relationship with the CEO can be established through memberships in the same clubs or associations which in turn could compromise the directors' judgment.[104] Core, Holthausen and Larcker (1999) have shown that CEO remuneration is higher when the outside directors are appointed by the CEO.[105] Similarly, Shivdasani and Yermack (1999) report that if the CEO is involved in the appointing process of new directors, less independent outside directors are chosen but more 'grey' outsiders with conflict of interests. Moreover, the selected candidates are less likely to fulfill their monitoring duty and the possibility is higher that they can be categorized as busy, meaning holding three or more board seats.[106]

[103] Cf. Fama, E. / Jensen, M.: Separation of Ownership and Control, 1983, p. 313f.
[104] Cf. Bhagat, S. / Black, B.: The Uncertain Relationship Between Board Composition and Firm Performance, 1999, p. 36.
[105] Cf. Core, J. / Holthausen, R. / Larcker, D.: Corporate governance, chief executive officer compensation, and firm performance, 1999, p. 372.
[106] Cf. Shivdasani, A. / Yermack, D.: CEO Involvement in the Selection of New Board Members: An Empirical Analysis, 1999, p. 1829-1831.

Table 6: Market reaction to Say-on-Pay Initiative by percent of outside directors appointed by CEO

	Number of corporations	Mean percent of outside directors appointed by CEO	Portfolio CAR (%)	T-statistic	P>|t|	Positive
1 Lowest	32	0.0%	-0.0204	-2.53	0.012	31.3%
2	19	22.9%	-0.0021	-0.2	0.838	47.4%
3	22	55.5%	-0.0078	-0.78	0.434	36.4%
4 Highest	24	94.3%	-0.0170	-1.75	0.082	50.0%

Source: Own illustration

Table 6 shows an inconsistent outcome. While firms in the first quartile with no outside directors have the highest negative abnormal returns, firms in the last quartile in which virtually all outside directors were appointed by the CEO report the second highest negative abnormal return. However, the figure of the first quartile is very close on being significant at the 1% level while the figure of the forth quartile is only significant at the 10% level. The first quartile is also the one with the lowest percent of firms with positive abnormal stock returns. The author interprets these results as follows. The market values the initiative as being the most disadvantageous for firms where no outside directors were appointed by the CEO. These outside directors should at least be independent in the sense that they don't maintain a personal relationship with the current CEO. Of course, if the corporation still provides financial support for a firm or an organization the director is additionally involved with a question mark remains.

The fourth variable to look at is *outside directors stock holdings*. Core, Holthausen and Larcker (1999) find no association between the stock holdings per outside director and CEO compensation.[107] Nevertheless, it could be that cumulative abnormal returns can be found during the event window as the initiative demands that shareholders not only have to validate the annual CEO's payment but also the total of all remunerations of the board of directors and of the management. The trust of investors in outside directors which hold themselves a significant ownership of share capital should be considerably greater than if the independent directors hold just a symbolic amount. Furthermore, as Kosnik (1987) writes, the existence of

[107] Cf. Core, J. / Holthausen, R. / Larcker, D.: Corporate governance, chief executive officer compensation, and firm performance, 1999, p. 372.

outside directors' stock holdings should further develop the directors' identification with shareholders as well as reinforcing the critical evaluation of manager's performance.[108]

Table 7: Market reaction to Say-on-Pay Initiative by outside directors' stock holdings

	Number of corporations	Mean outside director stock holdings	Portfolio CAR (%)	T-statistic	P>|t|	Positive
1 Lowest	25	0.00%	-0.0136	-1.48	0.139	36.0%
2	25	0.03%	-0.0068	-0.9	0.369	40.0%
3	25	0.19%	-0.0106	-1.11	0.267	44.0%
4 Highest	25	2.78%	-0.0225	-2.21	0.028	40.0%

Source: Own illustration

Table 7 shows the findings of the analysis. The fourth quartile, which contains firms where the outside directors own the biggest fraction of equity in comparison to their peers, is the one that accounts for the highest negative portfolio return, that is -0.02%. This figure is significant at the 5% level. Moreover, for the firms in the last three quartiles the negative portfolio return increases steadily as the stock holdings increase. This permits the interpretation that the market believes the monitoring of these outside directors to be more efficient and to be in accordance with their own interests. However, the percent of firms with positive abnormal stock returns stays around 40% in every portfolio which is why this conclusion has to be interpreted with caution.

The last variable to analyze is the *board size*. Yermack (1996) finds in his studies that there is an inverse association between board size and firm value.[109] Lipton and Lorsch (1992) assume that while the board's ability to monitor management activity increases with size, the benefits are still outweighed by the additional costs that arise. These encompass but are not limited to slower decision-making, less genuine debates about managerial performance and bias against risk-taking.[110]

Eisenberg, Sundgren and Wells (1998), however, raise concerns as to whether Yermack's study can be applied to smaller companies or companies operating in another legal or cultural

[108] Cf. Kosnik, R.: A Study of Board Performance in Corporate Governance, 1987, p. 171.
[109] Cf. Yermack, D.: Higher market valuation of companies with a small board of directors, 1996, p. 185.
[110] Cf. Lipton, M. / Lorsch, J.: A modest proposal for improved corporate governance, 1992, as cited in: Yermack, D.: Higher market valuation of companies with a small board of directors, 1996, p. 186.

environment.[111] Indeed Yermack himself reasons that “we should be cautious about concluding that the association holds at very small levels of board size”.[112] In his sample of the Fortune 500 industrial firms there were few companies with less than six members serving at the board (with a maximum of 24 members).[113]

Table 8: Market reaction to Say-on-Pay Initiative by board size

	Number of corporations	Mean board size	Portfolio CAR (%)	T-statistic	P>|t|	Positive
1 Lowest	64	4.5	-0.0215	-2.25	0.026	26.6%
2	66	6.4	-0.0160	-1.84	0.067	31.8%
3	35	8.5	-0.0129	-1.42	0.156	20.0%
4 Highest	41	11.4	-0.0087	-1.59	0.112	41.5%

Source: Own illustration

Table 4 shows the results of the analysis. As can be seen the negative cumulative abnormal return decreases monotonically as the board size increases with the first quartile having a CAR of -0.02% which is the only significant figure at the 5% level. Unfortunately, the pattern of percent of firms with positive abnormal stock returns doesn’t exactly match the return pattern. However, the one to break ranks is the third which happens to be the one with the lowest number of firms. That alone should not be a hindrance to disclaim the qualitative statement which is that as the board size increases the cumulative abnormal return becomes less negative. Despite the concerns stated above about Yermacks (1996) findings the author believes his thesis can nonetheless be applied to Switzerland especially as Eisenberg, Sundgren and Wells (1998) find the exact same board-size effect in their study of 900 Finnish firms. Here, it seems yet again that the firms which are in the portfolio that could be considered being composed of firms with better corporate governance is the one that gets punished the most by the market.

Based on the results of the five forgoing governance variables one can conclude the following. Even though there was not always a pattern identifiable between the four portfolios it is clear that in each and every occasion the portfolio containing the firms that can be considered to have exemplary corporate governance structure – in case of the particular

[111] Cf. Eisenberg, T. / Sundgren, S. / Wells, M.: Larger board size and decreasing firm value in small firms, 1998, p. 36.
[112] Cf. Yermack, D.: Higher market valuation of companies with a small board of directors, 1996, p. 196.
[113] The Fortune 500 is an annual list of the 500 largest companies in the United States. The list is compiled using the most recent figures for revenue.
Cf. http://www.answers.com, 27.12.2009 (Query).

governance variable looked at – was the one that got punished the most by the market in the three day event window. Moreover, in three of five instances the quartile with the 'weakest' governance is the one that gets the least penalized during the event window. This might come from the fact that investors seem to view the Say-on-Pay Initiative as less harmful for these firms because an enactment would increase the transparency and gives shareholders more access to the proxy.

Cai and Walkling (2009) reason in their analysis that firms with weaker governance are more probable to benefit from say-on-pay if they have the will to implement better compensation designs. This is why in their analysis the firms with the weakest governance didn't have the highest cumulative abnormal return but instead the firms in the third quartile. The investors expect the companies with the weakest corporate governance to be unreceptive to a shareholder vote as its nature is just consultative.[114] This could be the difference between their results and the one presented in this study as the Say-on-Pay Initiative in Switzerland demands a binding vote. Thus it is meaningless if the firms are *willing* to implement better compensation designs as they are *forced* to.

Taken together, the results of Tables 4-8 provide support for the interference hypothesis.

[114] Cf. Cai, J. / Walkling, R.: Shareholders' Say on Pay: Does It Create Value?, 2009, p. 20.

IV. Conclusion

The financial crisis pierced through the economic landmark like no other crisis since the great depression in the thirties of the last century. This was an ideal breeding ground for all kinds of regulatory propositions with say-on-pay being the last outflow to increase shareholders power and voting right in the boardroom. In Switzerland, it was Thomas Minder who started a federal initiative that wants to give shareholders a louder voice regarding total compensation of the firms' executives and board members.

To see whether said initiative adds value to firms three experiments are performed. In the first experiment, which is at the same time the corner pillar of this paper, the market reaction for 208 firms in the SPI® universe is observed. The author finds that there are significant abnormal returns surrounding the day the initiative committee announced it submitted the 100'000 needed signatures for a popular vote. Overall, the market valued this event as negative which leads to the conclusion that it sees the initiative as unconstructive. Furthermore, of the 56 firms with a significant abnormal return there were only four which reported a positive one. Interestingly, all of those companies had at that time a majority shareholder which could control the company. For these firms, the initiative is meaningless because a vote becomes redundant as only the opinion of the majority shareholder counts. But over two-third of the public companies listed in Switzerland are dominated by major or majority stockholders.[115] This means the existence of a majority shareholder can't be the striking point. However, it was established that in three of these cases the majority shareholder was at the same time the chairman of the board. As was demonstrated in section IV it can be assumed that the compensation design is already in the best interest of all shareholders in such a case. This supports the conclusion above because if the market actually views the initiative as harmful it makes sense that those firms benefit the most which already have an efficient compensation design *and* which wouldn't be affected by an enactment of say-on-pay.

In a second experiment it is examined whether a relationship between abnormal CEO compensation and the market reaction can be established. Say-on-pay seems to create value for firms with underpaid CEO's and to destroy value for others. These findings are surprising given the fact that one of the main reasons the initiative was established were the as too high perceived payments of top executives – tellingly, the original name of the initiative is "against

[115] Cf. KPMG's Audit Committee Institute: KPMG Kommentar zum Swiss Code, 2002, http://www.auditcommittee.ch/de/17951_18048.htm, 02.01.2010 (Query).

rip-off salaries”. The author stresses however, that the sample for this experiment consisted merely of the 45 biggest corporations in Switzerland and therefore didn’t contain mid or small cap firms.

In a third experiment it is tested if firms with good corporate governance benefit more by a possible change in legislation. For this purpose five corporate governance variables were conducted for a well diversified subset of firms in the SPI® universe. The author found that the market reaction was more pronounced for firms with good corporate governance as they have significant negative abnormal returns during the event window while in three of five cases firms with the weakest governance were the least penalized. This indicates that the market sees the Say-on-Pay Initiative as harmful for firms with good governance as it doesn’t add value but just creates additional costs arising from extended consulting processes with shareholders etc. For firms with the weakest governance the market seems to value the imitative as less harmful as it forces them to improve their transparency and gives investors more access to the proxy.

Taken together all experiments grant support for the interference hypothesis. These results provide valuable information on how the market perceives the federal initiative the Swiss people will most likely have to vote on in 2010.

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Appendix

A. Definition of Variables

The abnormal CEO compensation is defined as the residual of the compensation regressions shown in equation (3) and (4). The dependant variable is the log of the total compensation of the CEO. The independent variables are the log of the market capitalization, the market-adjusted yearly return and a dummy variable which equals one during the event window and zero for any other date. Additionally, in equation (4) the independent variables also include dummy variables and interaction terms to take different industries into account. Data is used from Kuipers, Schmid and Wagner (2009).[116]

As the basic idea of an outside director is to be independent and contribute by bringing objective and unbiased opinions to major corporate decisions the author defines an outside director as any member of a company's board of directors who is not an employee or stakeholder in the company or one of its affiliates.[117] In accordance with the Swiss Code of Best Practice for Corporate Governance the author defines a director as being independent if he or she is a non-executive member and was never or at least not during the three foregoing years part of the management of the company and stands in no or only minor business relationship with the firm.[118] This also means no significant shareholders which hold more than 3% of equity or representatives of them can be considered as being outside directors because they are stakeholders as well.

A busy outside director is classified as such if he or she holds more than three board seats in listed or unlisted companies or other similar legal entities (foundations etc.). An outside director appointed by CEO means the employment date was after the current CEO joined the firm. Once these variables are determined the author calculates for each company the percentage of its outside directors that are busy or appointed by CEO.[119]

Outside directors stock holdings equals the percentage of ownership of equity the outside directors of a firm hold. Normally this can be done by dividing the number of shares outside

[116] Cf. Kuipers, R. / Schmid, R. / Wagner, A.: PwC Executive Compensation & Corporate Governance 2009, 2009.
[117] Cf. www.investopedia.com, 03.01.2010 (Query).
[118] Cf. Economiesuisse: Swiss Code of best Practice for Corporate Governance, 2002, http://www.economiesuisse.ch/web/de/PDF%20Download%20Files/pospap_swiss-code_corp-govern_20080221_de.pdf, 03.01.2010 (Query).
[119] Cf. Cai, J. / Walkling, R.: Shareholders' Say on Pay: Does It Create Value?, 2009, p. 33f.

directors hold trough the total number of outstanding shares.[120] One has to be careful, however, as to what kinds of stocks are listed at the SIX Swiss Exchange. For example if only the bearer share of a company is listed than the number of bearer shares the outside directors own should be divided only by the total number of bearer shares.

The board size equals the number of directors serving on the particular board.

[120] Cf. Cai, J. / Walkling, R.: Shareholders' Say on Pay: Does It Create Value?, 2009, p. 34.

B. Chronology of the Swiss federal popular Initiative „against rip-off salaries“

To learn about the important dates of the federal initiative a look at the website of the Federal Chancellery is conducted as well as searching the “Swiss-Wide” headlines for events that are associated to the initiative.[121] To identify possible confounding events a search through LexisNexis is performed.

Table 9: Chronology of the Swiss federal popular initiative „against rip-off salaries“

Date	Say-on-Pay Legislation Sequence	Possible Confounding Event
July 31th- August 6th, 2006	A SonntagsZeitung article (08/06/2006) mentions that Trybol owner Thomas Minder has submitted the wording of his initiative text “against rip-off salaries” that week.	1) On 08/03/2006 the Associated Press reports that the European Central Bank (ECB) raised its interest rate by a quarter point to 3% as anticipated by analysts. However the Bank of England (BoE) gave a surprise by raising its interest rate by the same margin to 4.75%. 2) As reported in various headlines the oil price was under turmoil that week because of war in Lebanon and uncertainty of the severeness of the Caribbean hurricane “Chris”. 3) AWP Premium Swiss News informs that the net increase in employment in the US is below expectations which lead to believe that The Federal Reserve will not change interest rates after 17 increases in a row.
October 17th, 2006	The Federal Chancellery verifies the initiative complies with legal requirements.	1) On 10/18/2006 the Associated Press reports that the Federal Council of Switzerland had announced it entrusted five known experts the task to establish a federal audit supervisory authority.
October 31th, 2006	Thomas Minder begins collecting signatures for a federal initiative.	1) Economic Committee of the National Assembly agrees to establish a Swiss Financial Market Supervisory Authority (FINMA) with 14 to 4 votes.
February 26, 2008	Initiative Committee submits the 100’000 needed signatures.	1) No relevant confounding event found.

[121] Cf. http://www.bk.admin.ch/themen/pore/vi/index.html?lang=de, 21.11.2009 (Query).

April 2nd, 2008	The Federal Chancellery verifies the initiative as valid.	1) On 04/02/2008 the Swiss Market Index (SMI) gains 1.4% due to the extraordinary increases of the shares of the two major banks and in Tokyo the Nikkei reports a plus of 4.2%.
December 5th, 2008	The Federal Council of Switzerland advises to refuse the initiative and makes an indirect counterproposal with and addition to the ongoing revision of the Swiss Code of Obligations.	1) On 12/05/2008 the Swiss Market Index (SMI) loses partially more than 3% and closes minus 2.09%. The German Stock Index (DAX) even loses 4%.
May 12th, 2009	Judiciary committee of the Council of States tightens the indirect counterproposal and obliges to the initiative.	2) No relevant confounding event found.
June 11th, 2009	Council of States finishes debate over details of the counterproposal which is now less tight than the proposed form of the judiciary committee. The affair goes now back to the national council.	1) The Associated Press reports that the US budget deficit has ascended to a new high in May and is expected to peak at the record high of 1.84 trillion dollar at the end of the fiscal year.