University of Zurich[UZH]

Institute of Law

Compensation and Bonuses

Principles of Corporate Law / Gesellschaftsrecht (Master)

Lecture 8 – November 14, 2022

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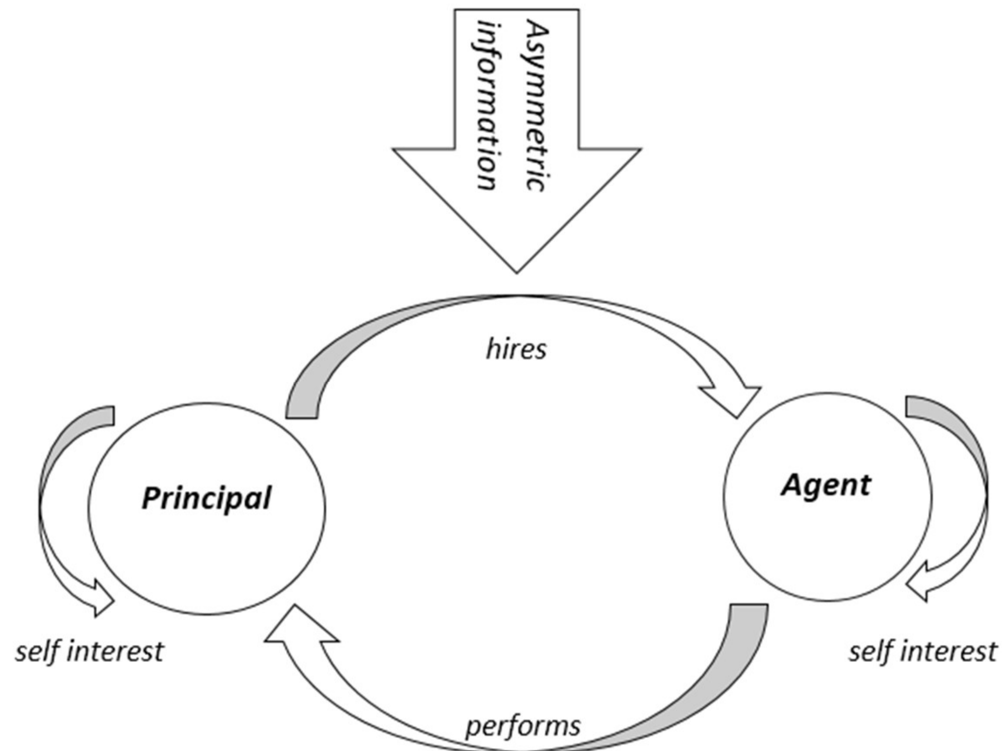
Main Points

- Background and main principles
  - Agency problem
  - Say on Pay
  - Remuneration through fixed salary or variable bonus?
  - Excessiveness?
  - Objectives of remuneration regulation
- EU, UK and Swiss regulation
- Focus on Financial services regulation

Principal-agent theory



Source: performancemagazine.org

Dealing with the agency problem (1): The stick

- 1st approach: Careful selection and close monitoring (i.e. reduction of information asymmetry); however:
- Costly for the principal (specialized personnel is necessary), because agents are difficult to control/individual performance is difficult to measure, especially in case of the CEO
- Public corporations with widely dispersed ownership:
  - Shareholder supervision of the CEO: Free-riding problem
  - BoD supervision: Who controls the controllers?

Dealing with the agency problem (2): The carrot

- 2nd approach: Incentivize the agent to act in principal's interest
  → Alignment of interests, attaining a "complete contract";
  but how?
- Promotions are (still) the primary incentive device in most organizations; however: They don't work for CEOs…
- Jensen/Murphy (1990): CEOs should own substantial amounts of company stock

→ CEO/agent becomes shareholder/principal;
caveat: interest/risk alignment with company only, not with society

- Posner (2009): Compensation as a screening device for agent's intrinsic commitment to the firm

Source: evolveconciousness.org

Remuneration options

- Fixed salary
- Payments to pension funds
- Linking pay on performance: Bonuses for success
  → Incentives through variable remuneration
- How to measure success? – share price, company revenues?
- Instruments for equity linked remuneration
- Short term gains vs. sustainability
- Windfall gains or the issue of rewarding industry (not firm) performance (c.f. horizontal shareholding, next slides)
- Delayed/deferred payments

Excursus: Horizontal shareholding

- Subject matter: Common set of (institutional) investors holding minority equity shares in multiple competing firms
- Synonym: Common ownership; ≠ cross shareholding
- Anticompetitive concerns: Common shareholders have an incentive to soften competition between firms because this increases profitability
- No need for coordination between common shareholders or common shareholders and firms‘ management
  – applicability of cartel law...
  (Art. 101 TFEU: „agreements [...] and concerted practises“; Art. 102 TFEU: [collective] market dominance; EC merger regulation)
- Empirical evidence: Airline and Banking industry – Increase in common ownership leads to higher ticket prices, banking fees and lower interest rates for deposit accounts

One alleged effect of horizontal shareholding: Remuneration for industry (not firm) performance

- Efficient remuneration policy should incentivise management to outperform firm‘s rivals
- However: If common shareholders aim for overall (industry) profitability, they favor remuneration for industry performance
- Empirical evidence:
  - Remuneration 70 % driven by general market performance and only 30 % driven by individual corporate performance
  - Institutional investors are more likely to prefer manager who maximise industry profits by avoiding competition

Is there “excessive” compensation?

- Jensen/Murphy (1990): Excessive pay is not the biggest issue, paying, on average, more is adequate when based on performance: taking the focus from *how much* to *how*
- Posner (2009):
  - Ethical concept of “just” reward (–)
  - Acceptable ratio between highest an lowest pay in the company (–)
  - Compensation is excessive when it is greater than it would be if agency costs were zero
- Executives are risk-averse with regard to themselves
- “Remuneration consultant dilemma”

Objectives of remuneration regulation

- Reduce principal-agent problem – asymmetric information; legal rules as default rules to fill the gaps of incomplete contracts, thereby reducing agency costs.
- Reward firm, not industry performance.
- Public policy concerns of taxpayer subsidies to financial firms (i.e. bailouts) that encourage failed business and risk management. Potential taxpayer subsidies encourage (even) greater risk-taking than what is socially optimal.
- Social and political backlash at huge salary differentials and big bonuses – “Occupy the City”, “Occupy Wall Street”

Overview: EU Approach

- Background: Complex web of overlapping legal & policy acts:
  EU/member states,
  code law/soft law (see further Swiss law)

- Since 2001, corporate governance principles
  (merely recommendations & guidelines)

- *Shareholder Rights' Directives (SRD I and II)* for all listed companies
- Main basis for remuneration reforms in financial sector:
  CRD III to CRD V package (consisting of Regulations & Directives)

  both partly based on Basel III/IV and 2012 EU Action Plan – «a modern legal framework for more engaged shareholders and sustainable companies»

SRD II

- SRD I (Directive 2007/36/EC), in force since Juli 31, 2007.
- SRD II (Directive 2017/828/EU), in force since June 6, 2017; national implementation deadline: June 10, 2019.
- Remuneration provisions *for listed companies* (Art. 9a and 9b SRD II):
  - Shareholders have right to vote (binding or advisory) on remuneration policy of BoD and at the minimum CEO/deputy CEO (regarding any substantial alteration or at least every four years);
  - Remuneration policy should present fixed and variable compensation and enclose criteria to which remuneration is linked;
  - Shareholders have advisory vote on companies' remuneration reports (implementation of the policy).
- National implementations, see next slide.
- Remuneration and Sustainability: Art. 15(3) C(orp)S(ust)D(ue)D(ilig)

Shareholders say-on-pay by selected EU states

State	Remuneration policy	Remuneration report
France	mandatory / annually	mandatory
UK	mandatory	advisory
Spain	mandatory	advisory
Italy	mandatory / triennially	advisory
Germany	advisory	advisory
Austria	advisory	advisory
Poland	mandatory	advisory
Finland	advisory	advisory
Belgium	advisory	advisory
Switzerland	see later	see later

cf. Sustainalytics (2019)

US Say-on-pay

- Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 as a reaction to 2007/2008 Financial Crises
- Consequently, Dodd-Frank Act largely deals with the regulation of financial institutions and instruments
- But also provisions on corporate governance, specifically say-on-pay
- Dodd-Frank Act §951 amended Securities Exchange Act to include §14A:

  Shareholder advisory vote *in public corporations* on

  (1) the compensation of the companies‘ most highly compensated executive officers („say-on-pay vote“);

  (2) the frequency of say-on-pay votes (annually, biennially, or triennially);

  (3) and certain golden parachute compensation arrangements.

EU requirements (CRD III to V packages) for financial service firms

Capital Requirements Directive III

- Effective January 2014
- Covers EU based *credit institutions, investment firms* & non-EU subsidiaries of such entities + EU subsidiaries of financial institutions headquartered outside EU (extraterritorial effects).
- Any staff with material risk (defined in Directives, interpreted & applied by EBA)
- Requires disclosure of variable pay for staff with material risk

Capital Requirements Directives IV and V –
Bonus elements effective 1 January 2015;
amendments to be implemented as of 28 December 2020

(+ regulations CRR I and CRR II)

EU requirements (CRD III to V packages) for financial service firms

- Limitation on firm's discretion to pay guaranteed variable remuneration
- 1:1 capped variable/fixed ratio (between 1-2:1 variable/fixed ratio if shareholders approve; member states can be stricter).
- Deferral of payment – 60% over (3 → 4 to) 5 years & at least 50% in equity-linked interests → **"50, 40/60 % rule"**
- Malus/clawback arrangements regarding variable pay (up to 100%)
- More restrictive measures to be imposed by the authority if bank does not meet its prudential targets
- Enhanced corporate governance (i.e. independent remuneration committees, disclosure rules)

Challenges of implementation

CRD III to V remuneration requirements
– especially rules-based bonus structures –
increase **complexity**

→ Difficult for shareholders and stakeholders to comprehend complicated rules/Limits effective disclosure to the market
→ Cost of control (internal [company]/external [authorities])

UK Companies Act 2006, SRD II implementation & Combined Code on Corporate Governance

Greenbury Committee 1995 – Code of Best Practice for Director's Remuneration. Remuneration committee consists mainly of non-executive directors to determine executive compensation (combined with Cadbury report 1992 and others, i.a. Higgs review 2003).

(Mandatory) vote on remuneration policy. SRD II implementation was not necessary since already in law.

Listed companies required to publish report on directors' remuneration as part of annual report and report specific details of director's package and CA 2006 s. 420.

Remuneration report must be submitted for shareholder approval (advisory vote; as a whole, not individual packages) by way of an ordinary resolution at general meeting where company accounts are laid. CA 2006 ss. 420-422A.
role of institutional investors

Performance-related incentives important. 1 year or less contracts for directors (Greenbury), but CA 2006 s. 188 allows for contracts > 2 years

UK financial sector remuneration regulation

Motivator: European Commission Recommendations (2009)

FSA Remuneration Code 2009 – implemented into FSA regulations.

Financial Services Act 2010 –

FSA statutory powers to require disclosure
Regulate the way banks pay employees
Recover *deferred* and *undeferred* compensation
(*malus* & *clawback*)

Implementation of CRD III up to CRD V (! → implementation deadline 28/12/20)

FRC (Financial Reporting Council: Audit authority)
– Corporate Governance Code Juli 2018, see next slide

Section 5 ‘Remuneration’ FRC Code 2018

- Remuneration committee: Consisting of independent non-executive directors; chair should have worked on a committee for at least 12 months; report should identify remuneration consultants, if appointed, and their connections; independent judgment on their advice
- Remuneration schemes: Should promote long-term shareholdings by executives (>5 years); specification of clawback/malus situations; only basic salaries should be pensionable (no pension on bonuses); pension contributions should be aligned with those available to the work force
- Contract periods: Should be one year or less; no reward of poor performance; reducing departing executives remuneration to reflect their obligation to mitigate company loss
- Remuneration committee work description in annual report: Explanation of strategic rationale, of appropriateness (i.a. regarding pay ratios), of how executive remuneration align with wider company pay policy
- General principles: Clarity, simplicity, risk awareness and mitigation, predictability, proportionality, alignment of culture

Switzerland: Perceived compensation excesses

Severance payments (golden parachutes) in 2008:

- Marcel Ospel (President B.o.D.): **CHF 2.3 Mil.**
- Peter Wuffli (CEO): **CHF 20 Mil.**
- Huw Jenkings (Chief Investment Bank): **CHF 20 Mil.**

Swiss corporate law governing remuneration

- Swiss Corporate Governance rules - 1991
- Board of directors (BoD) sole right to determine remuneration policy in private companies - Art. 716 CO
- Duty of loyalty and duty of care
- Before 2007, Board only had to provide information about remuneration upon request by shareholder(s) (if necessary for the execution of shareholders rights & not against general interests of company)

Amendments

- Art. 663b^bis CO in 2007:
  Requires detailed disclosure of total compensation
  (to board of directors & management board)
  of listed stock companies

- **Until 2013, Swiss corporate remuneration regulation was essentially 'soft law'**

  → BoD of Swiss listed stock companies were largely free to determine and approve compensation before the Ordinance Against Excessive Compensation entered into force in 2014

Soft law – Legally non-binding guidelines & recommendations

- Corporate Governance Directive (SIX)
- Swiss Code of Best Practices (economiesuisse)
- Financial Services: Remuneration Schemes (FINMA)

Objectives:

- More transparency & protection of shareholders
- «comply or explain-principle»

Minder Initiative

Daniel Vasella, CEO Novartis

40 Millionen Franken

UNIA

Jetzt abstimmen

Ja am 3. März

ABZOCKER STOPPEN

March 2013, approved by 67,9% of Swiss voters

Minder Initiative

- Art. 95 para. 3 Federal Constitution (FC) – not self-executable
- «Ordinance against Excessive Compensation (OaEC)»
- cf. EU SRD II

Major Amendments:
- Shareholders Say-on-Pay (binding)
- List of prohibited types of compensation
  - golden parachutes
  - golden hellos (but: compensation for “switching costs”)
- Criminal Sanctions for infringement (up to 3 years imprisonment)

Revision of the CO:
- Transfer of the OaEC provisions into the Code of Obligations (i.a. art. 732 ff. revCO) and the Code of Penalties (Art. 154 revCP) – certain increase of legal certainty

Art. 95 para. 3 Federal Constitution

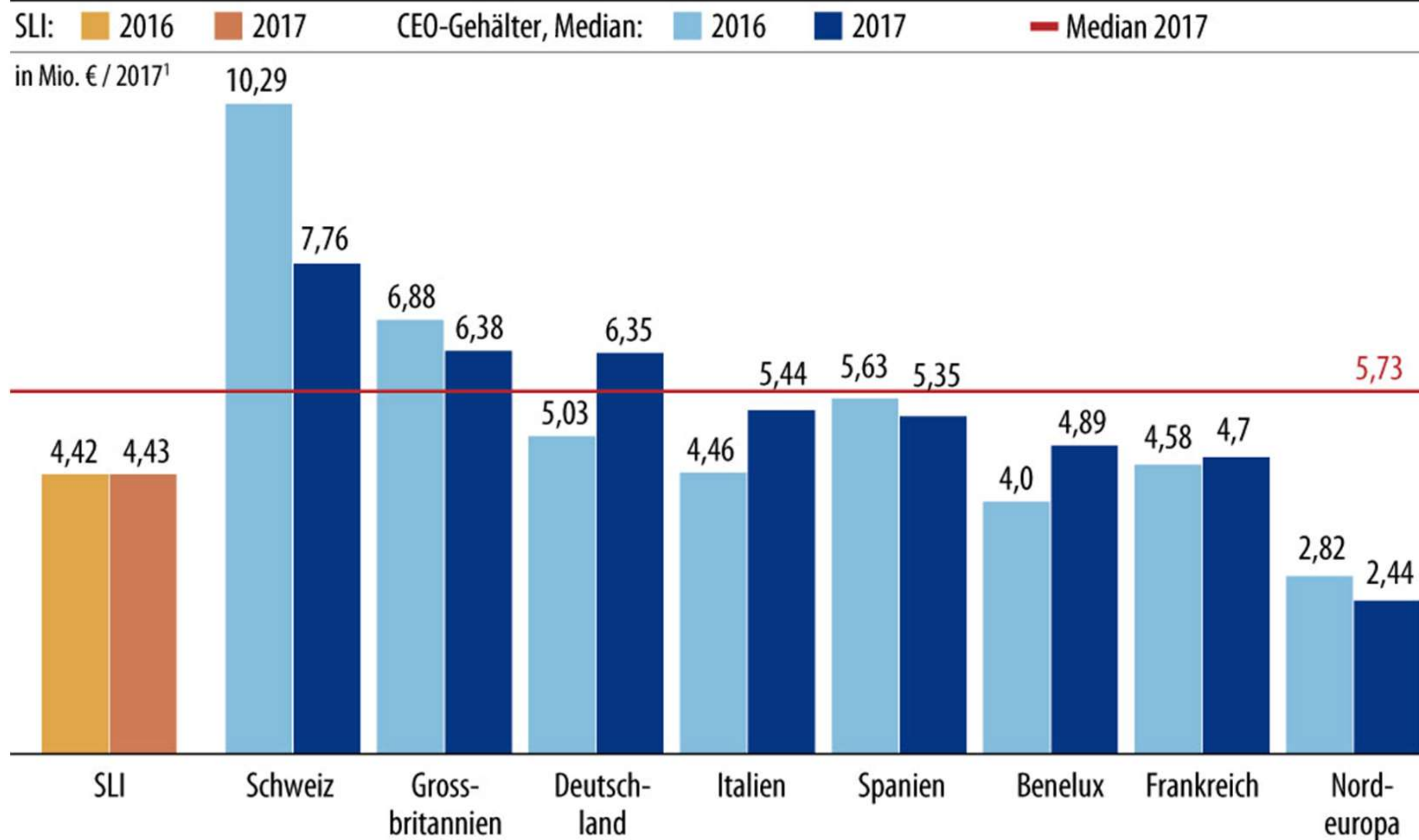
Say-on-Pay (Art. 95 para. 3 (a) FC):

"The general meeting votes on an annual basis on the total amount of all remuneration (money and the value of benefits in any kind) given to the board of directors, the executive board and the board of advisors. […]"

Prohibited list (Art. 95 para 3 (b) FC):

"The governing officers may not be given severance or similar payments, advance payments, bonuses for company purchases and sales, additional contracts as consultants to or employees of other companies in the group. […]"

Current Development – Top 100 EU companies



Swiss ‘1:12’ Initiative - 12:1 ratio of earnings of highest/lowest paid employee – 24/11/2013

Situation then

- Swiss company Victorinox (red penknives) – implemented 6:1 ratio highest earners to lowest earners
- Highest multiple – Severin Schwan 261:1 (2021: 307:1, according to newspaper “Work”)
- Nestle & Novartis also pay highest earner > 200 times
- UBS/CS/Sprüngli/Lindt – 200-100:1 ratios

Arguments against then

- Different industries require differing levels of expertise and companies can relocate high-paid earners
- Swiss multi-nationals have much higher than 12:1 ratio
- Minder-Initiative is “sufficient”

Clawback for financial sector in Switzerland?

Press release

Date:
01 November 2016

Embargo:

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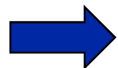
FINMA redefines corporate governance guidelines for banks



Finally, FINMA has decided not to introduce a clawback clause in the "Remuneration schemes" circular.

Conclusion

- Goal: “Pay for (firm) performance”
- Executive compensation perceived excessive in 1990s/2000s
- Transparency/Disclosure reduces information asymmetry
- Incentivise and align the interests of managers with shareholders rather than just limiting pay
- But in some cases – up-front banking – not sufficient because of excessive risk-taking that puts firm and society at higher risk. Therefore, remuneration regulation must be sensitive to both agency problems and social risks.
- Difficulties and challenges in determining the regulatory rules can lead to market unforeseen distortions