

## Complaint under the Competition Act 1998

### Comparative Pay Positioning in the Determination of Executive Pay

#### **Supplementary Information – June 2005**

##### **Introduction**

On 9<sup>th</sup> April 2005 I submitted a complaint to the Office of Fair Trading (OFT) concerning the use of comparative pay positioning in the setting of executive pay. On 26<sup>th</sup> April 2005 the OFT responded giving various reasons why they were not minded to investigate the matters raised in the complaint at that time.

This document is produced in response to the OFT's letter of 26<sup>th</sup> April 2005. It responds to the various points made by the OFT in that letter, and provides some further evidence. This document should be read in conjunction with the original complaint of 9<sup>th</sup> April 2005. The original complaint provides the background and explains many of the concepts, committees and codes of conduct referred to in this document.

##### **The parties and the agreement**

The OFT letter of 26<sup>th</sup> April says that the original complaint contained insufficient clarity about the parties to the agreement and the agreement itself. These matters are made clearer and more specific in this section.

In this complaint the undertakings in question are the 1000 or so individual people who provide services as company directors to FTSE 100 companies in the UK.

The anti-competitive practice consists of an agreement and a concerted practice. The agreement is the agreement to use comparative pay positioning as a means of setting the level of executive pay. This agreement is formalised and documented in supporting principal B.1. of the Combined Code 2003.

The concerted practice is the unwritten understanding between remuneration committee members (who are all undertakings for the purpose of this complaint) that they will avoid setting pay at levels below median position in a comparator group. The term “comparator group” is explained on page 7 of the original complaint.

The concerted practice is not a formalised agreement that is written down, but it is a practice vigorously promoted and supported by those who realise that they benefit from it.

### **The “Club”**

As stated above, the undertakings in this complaint are the individual people who provide services as company directors to FTSE 100 companies in the UK. The activities of these undertakings are closely co-ordinated through various associations both formal and informal. There is effectively a “Club” of FTSE 100 directors. The Club may have little formal definition but its power to influence the behaviour of its members is very significant.

Each FTSE 100 company board has a chairman, executive directors and non-executive directors, all of whom are undertakings for the purposes of this complaint. The chairman is responsible for leadership of the board. This can be a full time or part time role. A company chairman usually has decisive influence over the appointment of new members of the company board. Collectively, the FTSE 100 chairmen therefore have significant powers to control who joins the Club.

Apart from chairmen, other members of a FTSE 100 board are either executive directors or non-executive directors. Executive directors usually work full time for the company and have day to day responsibility for its management. Non-executive directors typically devote 20-30 days a year to the company. Their role is to provide appropriate checks and balances at the very top of the company. They constructively challenge and help develop proposals on strategy. They scrutinise the performance of management. They guard the integrity of financial information, financial controls and risk management systems. They usually serve on key board committees responsible for audit, remuneration and new appointments.

### **Attaining membership of the club**

Membership of the Club is difficult to attain and controlled by significant barriers to entry. The appointment of new non-executive directors was a particular concern of the report that Derek Higgs produced for the government in 2003. Despite the Combined Code requirement that, “There should be a formal and transparent procedure for the appointment of new directors to the board” (Combined Code 1988: A.5 Principle), Higgs found that, “A high level of informality surrounds the process of appointing non-executive directors. Almost half of the non-executive directors surveyed for the Review were recruited to their role through personal contacts or friendships. Only four per cent had had a formal interview, and one per cent had obtained their job through answering an advertisement. This situation was widely criticised in responses to the consultation, and I accept that it can lead to an overly familiar atmosphere in the boardroom.” (Higgs 2003: 10.5.) “Evidence diverged on the extent to which there is a shortage of good people to take on non-executive roles. Part of the problem seems to be however that the supply of talent that does exist is not being sufficiently drawn upon.” (Higgs 2003: 10.17) “It has been suggested that search consultants have a tendency to identify candidates from a narrow pool of candidates” (Higgs 2003: 10.19.)

Following the Higgs report the Combined Code was modified in 2003 to include more measures on the appointment of directors. However the Club vigorously opposed some of Higgs’ recommendations and certain recommendations never made it into the revised Combined Code. One such lost recommendation was that company chairmen should not also chair the board’s nomination committee which has responsibility for new appointments to the company board. The loss of this recommendation ensured that the Club retained very significant control over its new members. Despite the new version of the Combined Code it cannot be guaranteed that appointments are driven by the merit or the cost effectiveness of the possible candidates. Search consultants are still instructed by the nomination committee and new board appointments are still made by the existing board members. The Club therefore continues to regulate its new members. I have

attached Financial Times articles from 10<sup>th</sup> March 2005 and 11<sup>th</sup> May 2005, which illustrate continuing concerns in this area.

The competitive process is more obvious in selection (but not the pay!) of new executive directors. Executive directors are more usually appointed from within the company by the existing board members. There is normally a very significant growth in salary and benefits associated with being appointed as an executive director. This is true even where the appointment is being made internally. In such cases the company has clearly recruited, motivated and retained the individual for several years at much lower levels of pay. This suggests that membership of the Club carries with it benefits that significantly exceed what is necessary to recruit, motivate and retain the individuals in a competitive market.

### **Co-ordination of the Club**

The attitudes and behaviours of Club members are co-ordinated through various formal and informal associations. For example, the Institute of Directors (IoD) describes itself as a worldwide association which provides a professional network that reaches into every corner of the business community. “Our membership spans the whole spectrum of business leadership... Members receive a variety of benefits including information, advice, training, conferences and publications to help them to maximise their potential. They also have an influential organisation on their side – representing their concerns to government...” (IoD 2005: website).

Membership of the CBI (formerly the Confederation of British Industry) is for companies rather than for individuals. The CBI website states that 85 of the FTSE 100 companies are CBI members. The CBI is very effective in co-ordinating and defending the interests of FTSE 100 directors. A famous example of this occurred in March 2004 when the CBI organised a dinner at the RAC Club to reign in complaints from investment managers about executive pay and board appointments. I have attached a Financial Times article from 30<sup>th</sup> March 2004, which covers this story. Another example was the CBI’s initiative in setting up the Greenbury Committee in 1995. The Greenbury Committee defined most of what is still regarded as best practice in respect of board

room pay. The committee consisted of seven chairmen of top companies, the director general of the IoD, one senior company director and three representatives of the investment community, at least two of whom have been company directors themselves. It was also advised by two remuneration consultancies. Through this initiative the CBI ensured that the definition of best practice in executive pay remained firmly under the control of the Club.

The Club is also co-ordinated through highly effective networking among company directors. The power of the network is most obvious where one individual holds directorships on more than one board. Research conducted for the Higgs review found that 29 of the FTSE 100 chairmen held at least one non-executive post in addition to their chairmanship(s) (Hemscott 2003). The overlap would probably be more significant if non-listed companies and foreign companies were included. I have attached a Financial Times article from 1<sup>st</sup> November 2004 which illustrates the number of different board appointments that one individual (in this case Alan Leighton) can accumulate.

So the internal co-ordination of the Club is generally very effective. However, on the specific issue of executive pay the Club is co-ordinated with much greater coherence and effectiveness through the work of remuneration consultants. Remuneration reports must identify the consultants used. From these remuneration reports it is clear that the majority of large FSTE 100 companies use Towers Perrin as a consultancy, often in conjunction with other consultancies. This places Towers Perrin, and the other consultancies, in an outstanding position to co-ordinate policies between different remuneration committees. The role of remuneration consultancies was outlined in more detail in the original submission of 9<sup>th</sup> April. That submission shows that remuneration consultancies have great influence over remuneration committees. It also shows that they have strong incentives to push executive pay upwards. Co-ordinating the policies of remuneration committees gives them considerable scope to do this. In particular, they can promote the concerted practice of paying median level or above in a comparator group.

## **The concerted practice of paying at median level or above**

There is widespread agreement among members of the Club that, when reviewing executive pay, a remuneration committee should always seek to set salaries at median level or above compared to salary levels in a group of comparable companies.

This is actually a watered down version of an earlier practice which always sought to set executive salaries at the top quartile level within a comparator group. Under the old agreement executive salaries raced upwards very quickly. However the introduction of the Directors' Remuneration Report Regulations in 2002 required companies to make greater disclosure of their remuneration policies. Many companies are now reluctant to disclose any clear policy of seeking to remunerate at above median levels. This is because of an Association of British Insurers requirement, which states, "Where a company seeks to pay salaries at above median, justification is required" (ABI 2004: page 5, point 3).

By the very definition of the word *median* it is ridiculous for all companies to seek to pay at median level or above. By definition, only half of them could ever achieve this aspiration. The effect of the aspiration is therefore to force salaries upwards, rather than to achieve the stated objective.

If the market was truly competitive it would be completely impossible to adopt such a policy. For example, if all second hand car dealers were to agree never to sell a car for less than the price quoted in *Glass's Motoring Guide* then prices for second hand cars could only move upwards. Very soon second hand cars would start to appear expensive compared to new cars or cars sold through private sales. Pressure would build on the second hand car dealers because of falling sales and good opportunities for new entrants and private sales. This pressure would quickly lead to the agreement being broken and the market correcting itself.

However, in the case of the pay of executive directors we have seen more than twenty years of continuous price rises, often very rapid price rises. This reflects both the concerted practice, which drives the prices upwards, and market power which allows the practice to be sustained.

If the market for executive directors was truly competitive then members of remuneration committees would periodically think, “We can improve our company’s financial position by saving money on what we pay to the directors.” However, in the present climate such a thought is completely unthinkable for a member of a remuneration committee. Any movement towards more competitive pricing in executive pay would almost certainly hit the members own salaries both from the company in question and from other companies. A proposal to price competitively would be very badly received by the remuneration consultants and by other members of the company board who would all stand to lose out. Such a proposal could jeopardise the position of the non-executive director as a member of the remuneration committee or even as a member of the board. Worse still if the thinker got a reputation as a “loose cannon” then his or her continued membership of the Club would certainly be in danger. It is far, far more comfortable and personally profitable to go along with the received wisdom of paying at median level or above.

### **Evidence of the concerted practice**

Evidence of the concerted practice can be found in company remuneration reports. I have attached three remuneration reports for 2004 as examples. I must stress that these particular reports have been chosen because the quality of disclosure is high, not because the practice they document is worse than practice in other companies. Two of the three reports explicitly state that they seek to pay at median levels in the comparator group. One explicitly states that it seeks higher than top quartile levels, and gives a justification for this.

Many companies seek to pay at above median levels but do not wish to disclose this because of the ABI policy that “Where a company seeks to pay salaries at above median, justification is required” (ABI 2004: page 5, point 3). Many remuneration reports are therefore evasive about the position that they seek in a comparator group. They sometime use phrases like “position ourselves to retain a competitive advantage in pay” without being explicit on the position.

There are several examples of the Club promoting the concerted practise as though it is a fact of life, when in reality it is a statistical impossibility. For example, the Hempel committee stated that, “few remuneration committees will want to recommend lower than average salaries” (Hempel 1998: paragraph 4.4). Another example comes from an IoD response to a government consultation which includes the statement that “no-one is prepared to be paid (or to have a policy of paying) outside the upper quartile” (IoD 2003: page 2).

It is likely that the most compelling evidence of co-ordination between remuneration committees would be found in the advice that they receive from remuneration consultancies. This information is not however available to the public.

It might be argued that there is no Club-wide understanding to always pay at median level or above. It is simply that each remuneration committee faces a similar situation and independently arrives at a similar conclusion; this is not an agreement, but rather it is the market converging into a particular pattern. This argument is deeply flawed for several reasons.

First, the members of a remuneration committee are far less independent of the company board than they appear to be at first sight. An individual who appears unlikely to conform to the concerted practice is unlikely to ever be nominated onto a remuneration committee in the first place. Non-executive directors usually face re-election every three years and are most unlikely to be re-elected if they are not supported by other members of the board.

Secondly, most members of remuneration committees have a personal vested interest in executive pay moving upwards. It makes far more sense for them to co-operate in this process than to seek to expose their own earnings to competition.

Thirdly, considerable co-ordination of the work of remuneration committees occurs through the work of remuneration consultancies. As explained on pages 20-23 of the original complaint the remuneration consultancies have huge influence on the remuneration committees. There is a small group of remuneration consultancies who give advice to most FTSE 100 companies. Towers Perrin appears to be particularly influential.

Fourthly, the remuneration committees might reach similar conclusions because they face similar pressures, but these pressures are not the commercial pressures associated with needing to achieve the best deal for the company when hiring of directors in a competitive market. Rather the pressures are associated with balancing the needs of the various vested interest groups to whom they are accountable. Research done for the Higgs Review (McNulty 2003: pages 41-3) illustrates with practical experiences the many ways in which remuneration committees are influenced by company chairmen, executive directors and remuneration consultants as well as by shareholders.

Finally it is ridiculous for all remuneration committees to seek to pay median level or above. It is a statistical impossibility. There are no competitive markets in which a comparable practice is possible.

### **Price comparison on its own would not be a problem**

The OFT letter of 26<sup>th</sup> April points out that price bench-marking exercises are common in most markets and do not necessarily have an adverse impact on competition; in fact they often help competition. However, in the case of executive pay, the price comparisons are also linked to an unwritten agreement that prices should not be set below median level. It is this practice of setting prices at median level or above that is a breach of the chapter 1 prohibition.

The practice of setting prices at median level or above seriously undermines the competitive process. It creates a ratchet mechanism whereby prices can only move upwards. It ensures that prices cease to have any relationship with supply and demand. By promoting this practice among themselves, members of the Club protect themselves from price competition.

The insulation from competition is most clearly seen in the fact that supply and demand has no effect on prices. When a large number of high quality executives suddenly appear on the market, as happened after the Enron collapse for example, this does not result in any downward pressure on executive pay. Remuneration committees continue to pay their existing executives by making comparisons with other companies

existing executives and because of this concerted practice salaries can only move upwards.

The universal practice of seeking to pay above median would be impossible in a normal market because the rules of supply and demand would quickly force a price correction. However co-operation within the Club, and through remuneration consultancies, has insulated executive pay from competitive pressures.

### **Similarities between salaries for directors and wages for employees**

It was clear from my telephone conversation with David du Parc on 4<sup>th</sup> May, that the OFT saw some similarities between salaries for directors and wages for employees. Wages for employees are not usually examined under competition law, and this may be making the OFT reluctant to examine salaries for directors. There are however some very important difference between wages and directors' salaries.

One key difference, if I understood David correctly, is already recognised in European Law. There is a clear social benefit associated with rising salaries, but in contrast rapidly rising directors' fees have a socially detrimental effect. Their effect is similar to a tax paid by many to support the few who least need supporting. As I understand it, trade union agreements in Norway, although anti-competitive in nature, were ruled by the European Courts to be exempt from competition law because they had a social objective. As I understand it, the ruling specifically excluded the possibility of more select social groups ("liberal professions") appealing to the same social objective.

Like the directors' fees market, the wages market has moved only in an upwards direction since the early 1980's. However the rise in wages has been very small compared to the rise in directors fees. Also, unlike director's fees, wages can be understood in terms of supply and demand. Since 1981 economic growth has averaged around 2% per annum whereas population growth has averaged around 0.025%. This suggests that the labour market has been getting steadily tighter and explains why wages have steadily risen. If UK immigration laws were relaxed such that workers from the third world could enter the UK on a larger scale then we might reasonably expect wages to fall. The rise in directors' fees however cannot be explained in terms of supply and

demand. The Club has insulated itself from the effects of supply and demand. Supply and demand is discussed on pages 14-17 of the original complaint.

### **Dominance and Chapter II considerations**

By definition, only half of all companies can pay salaries at median level or above. It is therefore remarkable that so many companies have managed to increase directors' pay for many years on the basis of an impossible objective. Market dominance is almost certainly one of the factors that has made this possible.

Certainly an individual chief executive usually enjoys a position of competitive dominance. He or she has considerable power to demand a salary significantly above competitive levels and sustain this indefinitely. This power arises from many factors:

Firstly, company boards never want to forcibly dispense with incumbent chief executives. Any such attempt to dispense with a chief executive is guaranteed to cause huge problems, discomfort and difficulty in the board room. Above all, it will cause a great deal of additional work for the people involved. It is likely to destroy the relationships of trust and mutual support that are necessary in a board room. Finding a new chief executive might be difficult. Explaining the change to shareholders might be difficult. The credibility of those who recommended the original appointment might be threatened. Lawsuits might follow. The whole process could easily set the company back two years. No company board would ever want to contemplate this possibility, unless the situation was absolutely desperate. A chairman who believes that a chief executive is performing badly is far more likely to agree some form of succession plan that involves handover to a new chief executive in two years time, and a big pay-off for the outgoing chief executive.

Secondly the people who are most suitable to replace a chief executive are usually his or her direct reports. They are therefore not in a position to compete effectively. If a chief executive suspects that they are after the chief executive job then he or she usually has plenty of scope to damage their credibility and prospects.

Thirdly, the direct cost of boardroom pay is usually small relative to the size of a FTSE 100 company. This means that there is only limited commercial pressure to keep

boardroom pay in check. Value for money is not usually the most important factor in evaluating the performance of a chief executive. This gives the chief executive scope to overcharge.

Fourthly, the practice of comparative pay positioning ensures that the chief executives pay does not appear unreasonable compared to that of other comparable chief executives. This level may be far higher than the level that would be determined by true competition involving supply and demand, but the gap is concealed because all executive pay has moved upwards together.

Fifthly, the complexity and difficulty of evaluating executive pay makes it difficult for shareholders to articulate and justify specific complaints about executive pay.

An individual chief executive therefore has very considerable power both to overcharge for his or her services and to damage the prospects of his competitors.

This paper does not attempt to tackle the market definition work necessary to make a complaint under the Chapter II prohibition. However it is important to note that such a complaint could almost certainly be developed. The practice of comparative pay positioning unites the financial interests of all members of the Club such that they enjoy collective dominance. The concerted practice of seeking pay at median levels or above ensures that their levels of pay are raised above competitive levels. It is an abuse of the dominant position.

### **Data on executive pay levels in the UK**

The OFT letter of 26<sup>th</sup> April states that the original complaint contained insufficient data and analysis about executive pay in the UK. It should be noted that the analysis that I presented on pages 24-26 of the original complaint could be extended to provide evidence of a wider trend. To do this would, however, be very time consuming.

There is widespread agreement that executive pay grows very quickly, and has been growing quickly for many years. For example, I have attached a Financial Times article from 19<sup>th</sup> April 2005. This reports that the compounded annual rate of increase in executive pay at the biggest UK companies over the last five years has been 27%. This figure should be compared to annual inflation of about 2%. The report is based on data

produced by Independent Remuneration Solutions, which is one of the consultancies operating in this field.

The generation of data and analysis on executive pay is a task usually outsourced to remuneration consultancies. As is explained on page 5 of the original submission, executive pay packages have become very complex and difficult to value. This trend towards complexity has been supported by remuneration consultancies because it increases the size of their own business opportunity and reduces the transparency of executive pay to all but the professional remuneration consultancies. This makes it very difficult for non-professionals to comment effectively on the subject of executive pay.

To illustrate the analysis produced by remuneration consultancies I have attached a photocopy of a consultants' report by Deloitte. This examines executive directors' pay in listed companies for financial years that finished before February 2004. The document gives a detailed picture of the current situation in the UK.

## **Important Reference Material**

### ABI 2004

*Association of British Insurers – Principles and Guidelines on Remuneration – 7 December 2004* (available from: [http://www.abi.org.uk/Display/File/38/ABI\\_-\\_Guidelines\\_Draft\\_-\\_Final\\_Doc\\_-12\\_Nov\\_2004.doc](http://www.abi.org.uk/Display/File/38/ABI_-_Guidelines_Draft_-_Final_Doc_-12_Nov_2004.doc))

### Cadbury 1992

*The Report of the Committee on The Financial Aspects of Corporate Governance – 1<sup>st</sup> December 1992* (London: Gee and Co. Ltd) available from: [http://www.ecgi.de/codes/code.php?code\\_id=132](http://www.ecgi.de/codes/code.php?code_id=132)

### Combined Code 2003

*The Combined Code on Corporate Governance – July 2003* (London: Accounting Standards Board, Financial Reporting Council) Available from: <http://www.asb.org.uk/documents/pagemanager/frc/combinedcodefinal.pdf>

### Combined Code 1998 (superseded in 2003)

*The Combined Code: Principles of Good Governance and Code of Best Practice Derived by the Committee on Corporate Governance from the Committee's Final Report and from the Cadbury and Greenbury Reports.* Available from: [http://www.fsa.gov.uk/pubs/ukla/lr\\_comcode.pdf](http://www.fsa.gov.uk/pubs/ukla/lr_comcode.pdf)

### Greenbury 1995

*Directors' Remuneration: Report of a Study Group chaired by Sir Richard Greenbury – 17<sup>th</sup> July 1995* (London: Gee Publishing Ltd). Available from: [http://www.ecgi.org/codes/code.php?code\\_id=131](http://www.ecgi.org/codes/code.php?code_id=131)

### Hempel 1998

*Committee on Corporate Governance: Final Report – January 1998* (London: Gee Publishing Ltd) Available from: [http://www.ecgi.org/codes/documents/hempel\\_index.htm](http://www.ecgi.org/codes/documents/hempel_index.htm)

### Hemscott 2003

*The current population of non-executive directors – Full dataset – 20<sup>th</sup> January 2003* Available from: [http://www.dti.gov.uk/cld/non\\_exec\\_review/pdfs/finalcensus.pdf](http://www.dti.gov.uk/cld/non_exec_review/pdfs/finalcensus.pdf)

### Higgs 2003

*Review of the role and effectiveness of non-executive directors – January 2003* (London: DTI) Available from: [http://www.dti.gov.uk/cld/non\\_exec\\_review/pdfs/higgsreport.pdf?pubpdfload=03%2F636](http://www.dti.gov.uk/cld/non_exec_review/pdfs/higgsreport.pdf?pubpdfload=03%2F636)

IoD 2003

*Rewards for Failure – Directors Remuneration – Contracts, Performance and Severance – 30<sup>th</sup> September 2003* available from:  
[http://www.iod.com/intershoproot/eCS/Store/en/images/IOD\\_Images/pdf/Reward sforFailure.pdf](http://www.iod.com/intershoproot/eCS/Store/en/images/IOD_Images/pdf/Reward sforFailure.pdf)

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Website page *About Us* accessed 14/06/05. The page is at:  
<http://www.iod.com/is-bin/INTERSHOP.enfinity/eCS/Store/en/-/GBP/IODLeftNavigation-StartAbout;sid=YCH2ilRncCi6UxbXfRf8HPyn8lGFLAchG4w=?Target=Content&TemplateName=About%2fContent%2fabout%2eisml>

McNulty 2003 ( Dr Terry McNulty, Dr John Roberts & Dr Philip Stiles )

*Creating accountability within the board: The work of the effective non-executive director* available from:  
[http://www.dti.gov.uk/cld/non\\_exec\\_review/pdfs/stilesreport.pdf](http://www.dti.gov.uk/cld/non_exec_review/pdfs/stilesreport.pdf)

Myners 2001

*Institutional Investment in the United Kingdom: A Review* (London: HM Treasury) available from <http://www.hm-treasury.gov.uk./media/2F9/02/31.pdf>

Regulations 2002

Statutory Instrument 2002 No. 1986: *The Directors' Remuneration Report regulations 2002* (London: The Queen's printer of Acts of Parliament)

## Attachments

- 1 Financial Times article from 10<sup>th</sup> March 2005. Appointments: Are boards noticeably better after the Higgs reforms?
- 2 Financial Times article from 11<sup>th</sup> May 2005. Corporate Governance: Need to penetrate the marzipan layer.
- 3 Financial Times article from 30<sup>th</sup> March 2004. National news: Companies agree to keep channels open with investors.
- 4 Financial Times article from 1<sup>st</sup> November 2004. Companies UK: Leighton looks to step up his US activities.
- 5 Remuneration Report 2004: GlaxoSmithKline
- 6 Remuneration Report 2004: Vodaphone
- 7 Remuneration Report 2004: BG Group
- 8 Financial Times article from 19<sup>th</sup> April 2005. Companies UK: Executive pay: what is really happening.
- 9 Consultants Report: Deloitte – Executive Directors Remuneration – October 2004