

\*\*\*\*\*  
\*\*\*\*\*

\*\*\*\*\*  
\*\*\*\*\*

Solihull  
West Midlands \*\*\*\*\*  
9<sup>th</sup> September 2005

Jonathan May  
Director of Market and Policy Initiatives Division  
Office of Fair Trading  
Fleetbank House,  
2-6 Salisbury Square  
London EC4Y 8JX

Dear Mr May,

**Suggestion for a Market Study:**

**The use of Comparative Pay Positioning in the setting of Executive Pay**

I would like to suggest that the OFT conducts a Market Study in respect of the setting of executive pay, and the related market for recruiting and retaining executive talent.

My specific concern with this market is the practice of comparative pay positioning, which is advocated by the Combined Code on Corporate Governance. Comparative pay positioning requires that the pay of an executive is set by reference to what comparable executives are paid in comparable companies. This practice, in conjunction with an almost universal desire on the part of companies to pay their executives at median level or above, ensures that executive pay can only move upwards. It also ensures that executive pay, while purporting to be market driven, is completely unaffected by supply, demand and the forces of competition. The problem of comparative pay positioning is in many ways symptomatic of wider market problems, particularly the market power of incumbent company directors and the market co-ordination effects of remuneration consultants.

The market for executive talent is extremely important to the UK. Leadership positions throughout the private sector are sourced and paid for by reference to this market. Comparative pay positioning has ensured that for 16 years the price of executive pay has risen consistently at rates far in excess of average earnings growth. I estimate the current detriment to be £8bn per annum amongst listed companies alone, but this figure continues to rise year on year.

I have previously made detailed submissions about these matters to the OFT as part of a complaint under the Competition Act 1998. I received a letter from Mr John D Holmes dated 10<sup>th</sup> August 2005 (Ref: CE/6001-05) which acknowledges that the issues I raised were both important and interesting but he explains that they were not a priority for action within the Competition Enforcement branch of the OFT. When I discussed the matter with Mr Holmes on the telephone he explained that some of the market problems identified stemmed more from market wide structural issues rather than from breaches of the Competition Act by specific undertakings. He also thought it would be difficult to conclusively find a concerted practice but much more realistic to show that parallel behaviours were having an adverse affect on competition. He suggested that if the OFT were to engage with this issue then the Market Study/Market Investigation Reference approach under the Enterprise Act 2002 was likely to be a better way forward than enforcement action under the Competition Act.

I am therefore writing to you to request an OFT Market Study.

As Mr Holmes has pointed out, many of the competition issues relate to the Combined Code on Corporate Governance which is maintained by the Financial Reporting Council (FRC) and enforced through the Financial Services Commission's (FSC's) Listing Rules. I will therefore also be writing to these bodies, and others, to see what they can do to get these matters resolved.

It seems to me that there are compelling reasons why the OFT should conduct a market study on this topic. I have attached to this letter a schedule of reasons, as they have occurred to me. I have also attached my estimate of an £8bn detriment and some preliminary resources that the OFT might examine to inform its decision about a Market Study.

I very much hope that you will want to take this matter forward, and I would be very pleased to help you with this, to the extent that I can.

Yours sincerely,

Patrick Gerard

## **Reasons why a Market Study is a Good Idea**

The market for executive talent is a huge market of enormous consequence to the UK economy. Inland Revenue statistics for the tax year 2002/3 show that the 70,000 individuals whose employment income exceeded £200,000 had a total employment income of £22.4bn. (Source: [http://www.hmrc.gov.uk/stats/income\\_distribution/table3\\_6.pdf](http://www.hmrc.gov.uk/stats/income_distribution/table3_6.pdf).) Beyond its direct financial value the market is of the utmost importance because it is closely related to the leadership values that control the whole private sector of the UK economy.

The detriment associated with uncompetitive executive pay is enormous. I have attached an estimate that calculates the detriment to £8bn per annum in UK listed companies alone. In addition to this there are the knock on effects in professional firms and unlisted companies. Further detriment occurs because of the undesirable incentives associated with executive pay. Further detriment might occur if anti-competitive practices lead to sub-optimal executive appointments.

Many of the competition issues in the market for executive talent relate to the Combined Code on Corporate Governance which is maintained by the Financial Reporting Council (FRC) and enforced through the Financial Services Commission's (FSC's) Listing Rules. A study would therefore be concerned with the interaction between government and markets, which is one of the five priority areas identified by the OFT in its 2005/6 annual plan.

A study of executive pay would have significant benefits beyond the direct benefit in reduced detriment. A study of this issue is guaranteed to massively raise awareness of competition issues in company boardrooms across the country. It is a wonderful opportunity to explain the role of the OFT, its legal framework, the different actions it can take and the thinking behind these. Increased awareness and understanding of these matters would help the OFT in all its other interactions with business.

Executive pay has been a "hot potato" for many years and it seems to me that it is only a matter of time before the OFT is obliged to investigate it through some form of super-complaint. By initiating a study itself the OFT can be proactive in setting the agenda. It can ensure that it really is the competition issues that drive the investigation and that they do not become unduly obscured by public discontent or political concerns.

A Market Study would be relatively easy to conduct because most of the evidence is already with the OFT, or readily available from the internet. A suggested list of preliminary resources is attached. This also means that the Market Study could be conducted with minimal impact on the companies involved (except perhaps the remuneration consultancies). Companies might later be disrupted by the need to respond to issues raised by the study.

A Market Study is, in itself, a very appropriate form of intervention in the market for executive talent. The simple awareness that the subject is on the OFT's radar is likely to do a great deal to develop awareness of problematic behaviours and to improve competitive practices in that market.

A Market Study of this topic would highlight the important and distinctive roll of the OFT as an independent consumer champion and promoter of competition. Regulators such as the FRC and FSA are significantly less independent than the OFT. Inevitably their decisions reflect the vested interests of the main players involved and the resources available to those players to make their case. All too often the central concerns of competition, consumer interest and public good are lost, and this is where the OFT has an opportunity to demonstrate its value.

There has been significant public discontent with executive pay for many years. If the OFT were to be proactive on this matter then the public perception of the OFT as consumer champion would be greatly enhanced.

## **Estimate of the Detriment Associated with High Executive Pay**

The estimate is very difficult and it is necessary to make bold assumptions.

Let us assume that the level of executive pay was truly competitive in 1988.

### **Consider the chief executive of a top paying FTSE 100 company**

In 1988 the top paid chief executives in the FTSE100 were receiving total remuneration of just over £1,000,000 for the first time. (Source – Sunday Times 02/10/88)

Suppose that if executive pay had remained truly competitive then it would have risen at the same rate as average earnings. In other words, any increase at above this level can be attributed to anti-competitive effects.

The average earnings index rose from 53.5 in 1988 to 116.7 in 2004.

(Source – National Statistics - see

<http://www.statistics.gov.uk/STATBASE/Product.asp?vlnk=2484&ComboState=&More=Y&Btn.x=26&Btn.y=14>) This is equivalent to an annual compounded rate increase of 4.9954% per annum for 16 years.

If executive pay had risen at the same rate as average earnings then by 2004 the top paid chief executives in FTSE100 companies would have received around £2,181,308 ( $1,000,000 * 116.7/53.5$ ) in total remuneration in 2004.

Instead the top earning chief executives earned about £8m in 2004 (Source – Deloitte “Executive director’s remuneration, October 2004, page 84)

This suggests that the top chief executives in FTSE100 companies are paid about £5,818,692 more than they would be if the market was truly competitive. They are paid 3.667 times ( $8,000,000/2,181,308$ ) more than the competitive level.

### **Consider a top paying FTSE100 company**

Let us very crudely assume that the chief executive has 6 direct reports, each paid about £2,000,000 total remuneration in 2004 (c.f. Deloitte page 85), which was 2.6667 times more than competitive levels, which would be 750,000 ( $2,000,000/2.6667$ ). In total they are paid 7,500,000 ( $6*(2,000,000-750,000)$ ) more than competitive levels.

And at level 3 in the organization let us assume that there are 36 executives who are each paid £800,000 in total remuneration, which is 2 times the competitive level of £400,000. Therefore in total they are paid £14,400,000 ( $36 \times 400,000$ ) more than competitive levels.

At level 4 in the organization let us assume that there are 216 executives who are paid £400,000 in total remuneration which is 1.333 times the competitive level of £300,000. Thus in total they are paid £21,600,000 ( $216 \times 100,000$ ) more than competitive levels.

Let us assume that below level 4 all salaries are competitive.

Then at a top FTSE100 company the total pay is £49,318,692 more than competitive levels ( $£5,818,692 + 7,500,000 + 14,400,000 + 21,600,000$ ). Let us think of this as £50,000,000 for simplicity.

### **Consider all listed companies in the UK**

Excessive executive pay is a problem associated more with the bigger listed companies. Let us therefore assume that the 1500 or so smaller listed companies are paying executive salaries at competitive levels, along with the smallest FTSE 350 companies. Let us assume that the biggest FTSE 350 companies are paying £50m per annum more than competitive levels for their executives, as seen above. Let us assume that FTSE350 companies between the smallest and the biggest are paying over competitive levels on a linear basis between zero and £50m. There are about 320 FTSE350 companies if the 30 investment trusts are excluded.

On this basis the total amount paid by listed companies in excess of competitive levels is about £8,000m ( $0.5 \times 320 \times 50$ ).

### **Consider the effect across the whole UK private sector**

In addition to the £8bn per annum of detriment estimated in listed companies above there is a further detriment caused by the impact of high executive pay in parts of the private sector beyond listed companies. The high level of disclosure of executive pay in listed companies makes it a natural benchmark for executive pay in professional firms and companies which are not listed on a stock exchange. It is therefore very likely that the total detriment to the UK economy is significantly more than £8bn per annum.

**Consider the detrimental affects associated with poor incentives**

In addition to the £8bn per annum of detriment estimated in listed companies above there is a further detriment caused by the very damaging incentive arrangements that arise from high executive pay. Pay is usually meant to be linked to performance, but often these links are very badly made and it is common for executive pay to create incentives for executive behaviours which are value destroying for companies in the long term. This is the topic of my book (see preliminary resources).

**Consider the detrimental affects caused by sub-optimal appointments**

It is possible that the anti-competitive arrangements affecting the level of executive pay are also causing the wrong people to be appointed to the top jobs in the UK's private sector. If this is the case then a further significant detriment arises.

## **Preliminary Resources for examining executive pay**

The following resources might be of help to the OFT in making a decision about a Market Study on executive pay.

- (1) My complaint to the OFT under the Competition Act 1998 dated 9<sup>th</sup> April 2005. This is available from Mr John D Holmes in Competition Enforcement 5 (Ref: CE/6001/05). It contains a lot of background information about the way that executive pay is determined in the UK and the consequences of the Combined Code on Corporate Governance. The OFT's response, dated 26<sup>th</sup> April is also relevant.
- (2) My subsequent submission dated 28<sup>th</sup> June, together with all its attachments, attempts to show much more specifically that there is a concerted practice of seeking to pay at median level or above. One attachment is a report from Deloitte called "Executive directors' remuneration" which gives a lot of detail about current practice in executive pay. The OFT's response, dated 10<sup>th</sup> August is also relevant.
- (3) Page 14 of my 28<sup>th</sup> June submission lists important reference material, most of which is available on the internet.
- (4) Company remuneration reports are readily available on the internet. Most companies have an Investor Relations website from which the Annual Report and Accounts, including the Remuneration Report, can be downloaded.
- (5) I would recommend the book "Pay without Performance: The Unfulfilled Promise of Executive Compensation" by Lucian Bebchuk and Jesse Fried (Harvard University Press, 2004). This book is about the situation in the US rather than the UK, but US practice has been very influential in the UK and the book is particularly good at showing how market power has been used to push the price of executive pay upwards, without reference to supply, demand, competition or performance.
- (6) I would also recommend my own book "Performance and Reward: Managing Executive Pay to Deliver Shareholder Value" which I hope to have published later this year. (I could supply a draft copy now.) The book shows how a UK

company's executive pay schemes would be structured if they were serious about rewarding performance. It also shows how current arrangements can be explained in terms of the incentives on the various people who influence executive pay rather than by the desire to improve performance or by effective competition.

- (7) I have attached two recent and relevant Financial Times articles from FT.com.