Controlling Executive Remuneration: Securing Fairer Distribution of Income

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by

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The contents of this document form a submission to Labour’s policy making process; they do not constitute Labour Party policy nor should the inclusion of conclusions and recommendations be taken to signify Labour Party endorsement for them.

This report is promoted by Rebecca Long-Bailey MP, Shadow Business Secretary, and John McDonnell MP, Shadow Chancellor of the Exchequer at House of Commons, Westminster, London SW1A 0AA.

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EXECUTIVE SUMMARY

This paper makes a number of recommendations to curb undeserved executive pay and also create mechanisms for better distribution of income. It recommends that employees and consumers should be empowered to vote on executive pay in large corporations and thus exert pressure for better distribution of income and improved quality of service for consumers. It calls for disclosures and revised remuneration approval practices.

The proposed reforms would apply to over 7,000 companies, classified as large companies under the UK Companies Act 2006. The proposals are detailed in the paper. The following list provides an overview.

1. In designing and fixing executive remuneration packages, a company must demonstrate that it has given due regard to the interests of its employees and consumers, and its investment and capital needs.

2. Executive remuneration contracts in large companies to be made publicly available.

3. The cult of bonus payments to be discouraged. Bonuses, if any, should only be paid for carefully specified and extraordinary performance.

4. Pay differentials between executives and employees analysed by gender and ethnicity to be published.

5. Companies to be required to reveal the names and number of employees, analysed by gender and ethnicity, earning more than £150,000 per annum in brackets of £10,000.

6. Central and local government authorities to apply a ‘fit and proper’ person test to all suppliers seeking public contracts of £5 million or more. As part of the test, bidders/suppliers to be required to disclose the total number of employees and the proportion, analysed by gender and ethnicity, receiving remuneration of more than £150,000 per annum in brackets of £10,000.

7. Directors to explicitly state in their annual report, that no employee has received remuneration which is less than the National Minimum Wage or the Living Wage. In the event of wilful or persistent failure to pay the legally mandated rate of pay, a minimum fine equivalent to the remuneration of the entire board should be levied and at least 50% of that should be paid by the directors personally.

8. If executives are required to hold company shares they are to be purchased with their own resources rather than provided by the company.

9. Executive remuneration to be in cash as rewards in share options, shares and perks invite abuses and complicate the calculation.

10. Executive remuneration packages must not be changed to compensate executives for changes in their personal tax status.
11. In large companies, all executive remuneration contracts are to be formulated by the company board (or stakeholder board in the case of two-tier boards). It may wish to be advised by a remuneration committee. If such a committee is created it must have representatives of employees and other stakeholders.

12. The remuneration of each executive at large company to be the subject of an annual binding vote by stakeholders, including shareholders, employees and consumers.

13. The vote on executive remuneration to be in two parts.

   (a) The basic remuneration of each executive can be the subject of a simple majority vote by all stakeholders.

   (b) The stakeholder ballot for the incentive-based element for each executive to require a two-stage approval.

   (i) There needs to be a 50% turnout.

   (ii) In addition, there must be support from at least 90% of all voting stakeholders to approve each item of bonus and other incentive-based payments.

14. If 20% of stakeholders vote against remuneration policy or remuneration of any executive then all directors to receive a warning (a yellow-card). Following, the first yellow-card, the company’s next remuneration report must explain the Board’s response and the action taken to address stakeholder concerns.

   If for the second consecutive year, 20% or more of the eligible stakeholders reject the remuneration report, a second warning (or a yellow-card) must be issued. This would automatically trigger an additional resolution for the accompanying AGM. This resolution must consider whether the executive and stakeholder directors, with the exception of the managing director and/or chairman, need to stand for re-election. If this resolution is supported by 50% or more of the eligible stakeholders then a meeting to consider re-election of directors must be convened in accordance with the requirements of the Companies Act 2006 or any new provisions that might need to be enacted.

15. Company law to be changed to give stakeholders the right to fix an upper limit i.e. ‘cap’ executive remuneration package.

16. The Companies Act must provide a framework for claw back of executive remuneration.

17. Golden handshakes, hellos, handcuffs, parachutes, goodbyes and severance have all become a way of boosting executive remuneration and must be prohibited.
18 In the case of companies with deficits on their employee pension scheme, their directors must not be eligible to receive any bonus or increase in remuneration unless they have reached a binding deficit reduction agreement with the Pensions Regulator.

19 There needs to be an upper limit on the tax deductibility of total executive remuneration for each person. The proposal penalises companies that continue to engage in inequitable distribution of income.

20 A newly constituted Companies Commission to oversee and enforce the above and other aspects of the UK company law.
CHAPTER 1
INTRODUCTION

Persistent inequalities in the distribution of income and wealth are a key social problem. Inequitable distribution of the wealth generated by the brawn and brains of employees exacerbates inequalities.

A recent report\(^1\) shows that the average income for all households in 2017/18 increased by just 0.9\%, the lowest rise for four years and that is less than half the average between 1994 and 2007. In real terms millions are worse off. In 2003, households on the lower half of incomes earned £14,900, after inflation and housing costs, but by 2016/17 it declined to £14,800. Poverty and inequality is on the rise.

It is an entirely different picture at the other end of the pay spectrum. After just three working days in 2018, the UK’s top executives made more money than the typical UK full-time worker will earn in the entire year\(^2\). A 2017 study\(^3\) reported that the highest FTSE 100 executives collected an average of £4.5 million, equivalent to 160 times the average earning and 262 times the Living Wage. Despite a pay cut, WPP chief executive Sir Martin Sorrell (now departed) received £48.1 million, equivalent to 1,718 times median earnings in the UK and 2,533 times the lowest paid job in his own company. At Persimmon\(^4\), a construction company, its chief executive received £100 million, equivalent to 1,320 times the average pay and 3,195 times more than the lowest paid job at the company.

The challenge is not only to devise mechanisms that constrain undeserved executive pay in large companies but also create mechanisms to enable workers to secure an equitable share of income/wealth created with their own brain, brawn, sweat, commitment and energy. The key to that is to empower employees of large companies to vote to executive pay.

Customers are the backbone of all enterprises but are increasingly being poorly treated though profiteering by banks, gas, water, electricity and other companies. They should be empowered to penalise executives delivering poor goods/service and equally also reward those delivering high quality products and services. They too need to be empowered to vote on executive pay in large companies.

The above reforms need to be accompanied by reforms to enhance transparency, mechanisms to restrict undeserved executive pay and enforcement of the statutory

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\(^2\) The High Pay Centre, It’s Fat Cat Day - Thursday Jan 4 2018; http://highpaycentre.org/blog/its-fat-cat-day-thursday-jan-4-2018
\(^4\) The Independent, Persimmon: Will £100m CEO Jeff Fairburn accept blame if the roof falls in as some analysts fear? 5 July 2018; https://www.independent.co.uk/news/business/comment/persimmon-builder-jeff-fairburn-100m-pay-package-housing-market-rachel-rees-parliamentary-business-a8432426.html
framework proposed in this paper. The remainder of this paper is organised in four further chapters. Chapter 2 provides a broad analysis of current executive pay and its links with employee pay. Chapter 3 explains the social consequences of the inequitable distribution of income. Chapter 4 shows that successive governments have assumed that shareholders and voluntary codes of corporate governance would somehow check undeserved executive pay and a more equitable distribution of income. Such policies have failed and alternative reforms are needed. Chapter 5 provides details of the proposed reforms which would apply to all large companies and groups of companies, as defined by the Companies Act 2006 i.e. companies or groups of companies with more than 250 employees. A statutory framework is essential for dealing with executive remuneration and the ability of stakeholders to ensure that it is deserved and equitable. The proposals call for disclosures, new arrangements for securing approval of executive remuneration, prohibitions and enforcement. Chapter 6 concludes the paper with brief reflections on its analysis and reform proposals.
CHAPTER 2
THE CONTEXT OF EXECUTIVE PAY

Persistent inequalities in the distribution of wealth and income affect people’s access to food, housing, pensions, education, healthcare, access to media and ability to shape democratic choices. The 2018 data published by the Office of National Statistics\(^5\) shows that the UK’s wealthiest 10% of households owned 44% of aggregate total wealth. In contrast the least wealthy 50% of the households owned just 9% of total wealth and middle wealth households (51% - 90%) had 44% of wealth.

One of the reasons for the persistence of the above patterns is inequitable distribution of income. A disproportionate share continues to be appropriated by economic elites. In the 1980s a typical FTSE 100 top chief executive was paid approximately 20 times as much as the average British worker, but by 2002 this had risen to 69.51 times and to 149.58 in 2014 (Figure 1\(^6\)).

![Figure 1](FTSE 100 CEO remuneration to average employee pay 2002–2014)

Executive pay ratio temporarily dipped after the 2007-2008 banking crash, but has returned to its upwards trend. A 2017 study\(^7\) reported that the highest FTSE 100 executives collected an average of £4.5 million, equivalent to 160 times the average earning and 262 times the Living Wage. Despite the recession, CEO median pay rose by 11% between 2016 and 2017, from £3.53 million in 2016 to £3.93 million in

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Executive pay is detached from economic growth, productivity and wage levels for workers. In 2005, CEO compensation, including pensions and share awards, was just 0.1 percent of pre-tax profits, and by 2015 despite the recession a decline in the FTSE100 index it reached 0.58 percent of profits. Thomas Piketty calls today's chief executives a generation of “super-managers,” who, for the first time in history, are able to become independently wealthy by running a public company for a handful of years. Clearly, the distribution of income is highly skewed in favour of a small minority.

Executive pay at FTSE 100 companies consists of a complex amalgam of basic salary, pension benefits, other benefits, bonuses and various long term incentive payments which are triggered at specific points in time (Figure 2). It should be noted that the total remuneration far exceeds the actual performance of FTSE.

Figure 2
Structure and levels of executive pay

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9 Reuters, Bosses take bigger share of top British firms' profits, 6 May 2016 (http://www.reuters.com/article/us-britain-executivepay-idUSKCN0XX1DK).
Compared to their counterparts in other European countries, UK executives receive higher bonuses for assumed superior performance (Figure 3\textsuperscript{11}).

**Figure 3**

CEO Pay – Basic Salary and Bonuses

![](image)

Incentive pay is most significant in the German, UK and Swiss companies.

The bonus and incentive payments are supposedly overseen by non-executive directors and remuneration committees, but there is little link between actual corporate performance and executive pay. For example, at Carillion\textsuperscript{12}, a company that crashed with massive debts, the board presided over low levels of investment, declining cash flow, rising debt and a growing pension deficit. Yet the pay of directors rocketed. Its three non-executive directors collected more than £60,000 each for working around one day a month and did not oppose any of the pay rises for directors.

The financial sector has been a serial offender and actively engaged in mis-selling financial products, rigging foreign exchange rates, interest rates, money laundering, tax avoidance and tax evasion to boost profits, shareholder returns and performance related executive pay. The US and European regulators have imposed $342 billion of fines on banks since 2009 for misconduct and the amount is expected to top $400 billion by 2020\textsuperscript{13}. British banks, such as HSBC, Barclays and Royal Bank of Scotland (RBS) have been heavily fined. Despite predatory practices, non-executive directors


and remuneration committees have allowed executive pay to soar. The heads of 11 European banks have collected an average of $10.4 million\textsuperscript{14}. Total UK bonus payouts, mostly in the financial sector, in the year to the end of March 2016 rose to £44.3 billion\textsuperscript{15}. The linking of pay to corporate earnings has incentivised executives to develop strategies to shift profits and avoid taxes\textsuperscript{16}. There are no statutory mechanisms for clawing back bonuses though a number of companies claim to have mechanisms for clawing back some of the bonuses at the board’s discretion\textsuperscript{17}.

A report by Incomes Data Services showed that that there is either no relationship or at best a weak link between directors’ pay and performance. Executive remuneration could not be justified by the level of pre-tax profits, growth in earnings per share, or even shareholder returns\textsuperscript{18}. The industry itself has acknowledged that “Rising levels of executive pay over the last 15 years have not been in line with the performance of the FTSE over the same period\textsuperscript{19}”.

Over the last 30 years the share of income going to the top 1% has doubled from 6% to 14%. In the financial year ending 2017, the average income of the richest fifth of households before taxes and benefits was 12 times greater than that of the poorest fifth\textsuperscript{20}. Between 2007 and 2015 in the UK, real wages fell by 10.4%, the joint lowest in OECD countries\textsuperscript{21}. In sharp contrast, executive remuneration has increased. The relationship between executive pay and employee pay is captured by the Business, Energy and Industrial Strategy Committee’s 2017 report (Figure 4)\textsuperscript{22}.

\textsuperscript{14} Financial Times, Pay for big bank chief executives jumps nearly 8%, 12 July 2016 (https://www.ft.com/content/80406e0e-3334-11e6-ad39-3fee5ffe5b5b).
\textsuperscript{17} Deloitte, Directors’ remuneration in FTSE 250 companies 2015 (http://www.deloitte.co.uk/executivemeruneration/assets/pdf/ftse250-report-2015-main-findings.pdf)
\textsuperscript{21} The Guardian, UK joins Greece at bottom of wage growth league, 27 July 2016; UK joins Greece at bottom of wage growth league
\textsuperscript{22} House of Commons Business, Energy and Industrial Strategy Committee, Corporate governance London: House of Commons, 2017, p. 35.
At the other end of the pay spectrum, workers are being squeezed. The Low Pay Commission estimates that 1.9 million jobs are paid at or below the National Minimum Wage (NMW) in April 2017, compared to 1.5 million in 2015. The coverage of the NMW is expected to increase to 3.4 million employees by 2020\textsuperscript{23}, or 4.2 million people as the UK moves towards the new National Living Wage target\textsuperscript{24}. Despite the legal requirement, thousands of employees do not to receive the NMW and the regulatory regime is not biting\textsuperscript{25}. Those most likely to be low paid include women, the young, part-time and temporary employees, those in lower-skilled occupations, and those employed in the hospitality, retail and care sectors. Of course, men are not immune. The number of men in low-paid part-time work has increased fourfold over the past 20 years\textsuperscript{26}. Whilst executive pay has soared, the wages of ordinary workers have fallen by an average of 1% between 2008 and 2015, putting the UK in 103rd place in a global ranking of pay growth\textsuperscript{27}. Over 1.5 million people were destitute in the UK in 2017\textsuperscript{28}. In April 2018, due to low pay and stagnating wages 1 in 8 workers were living in poverty and once inflation is taken into account, average workers were still earning £25 per week less than 10 years

\textsuperscript{24} Resolution Foundation, Low Pay Britain 2018, May 2018.
\textsuperscript{25} For example, see HMRC, 200,000 receive back pay as HMRC enforces National Minimum Wage, 9 May 2018; National Audit Office, Ensuring employers comply with National Minimum Wage regulations, London: NAO, May 2016.
\textsuperscript{26} The Institute for Fiscal Studies, Dramatic rise in proportion of low-wage men working part time, 13 January 2017 (https://www.ifs.org.uk/publications/8850).
\textsuperscript{28} https://www.jrf.org.uk/press/over-one-and-a-half-million-people-were-destitute-uk-2017
ago. Joseph Rowntree Foundation reported that some 14 million people, including those at work, live in poverty - that is more than one in five of the population.

A 2017 report published by the Equality and Human Rights Commission reported the institutionalisation of a persistent ethnicity pay gap. Despite equality laws, ethnic minorities continue to earn less. For example, male Bangladeshi immigrants earn around 48% less than their white counterparts. British born Bangladeshis experience pay gap of around 26%. Pakistani immigrant men experienced a 31% pay gap, while British-born Pakistani men experienced a pay gap of 19%. For immigrant and British-born Black Caribbean men the pay gaps are 17% and 7% respectively. Female Bangladeshi immigrants and Pakistani immigrants both experienced around a 12% pay gap compared with White British women.

The inequitable distribution of income has consequences for quality of life and social stability. Such issues are explored in the next chapter.

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CHAPTER 3
CONSEQUENCES OF INEQUITABLE DISTRIBUTION

The relationship between rising income inequalities and social problems is well established and is captured in the chart below by the work of Richard Wilkinson and Kate Pickett (Figure 5).  

**Figure 5**

**Health and social problems are worse in more unequal countries**

Inequalities in the UK have severe implications for access to good housing, education, food, pension, healthcare, transport, justice, security, democratic institutions and much more. Households on low income have shorter life expectancy, higher stress, infant mortality, health and psychological disorders.

The lack of disposable income is damaging to economic growth as normal people lack the resources to build a sustainable economy and cannot indefinitely rely on debt to meet their essential needs. Normal people spend a large proportion of their income on everyday items and this spending has a greater multiplier effect on the economy. In contrast, wealthy households spend a smaller proportion of their income on everyday things and may spend more on speculative goods, which may create...

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speculative bubbles and some jobs for intermediaries (accountants, lawyers, art dealers, financial services experts) and their multiplier effect tends to be low. A more equitable distribution of income has a greater beneficial effect on the economy.

Inequalities create alienation, social divisions and segregation as those on low pay become trapped in dilapidated neighbourhoods and face diminished opportunities for social advancement. The inequalities have fuelled the payday lending industry and an explosion in personal debt. At the end of April 2018, UK household debt is estimated to be around £1.592 trillion34 and is predicted to rise to £2.296 trillion by 2022. By the end of 2017, workers’ share of GDP has shrunk to a record low of 49.14%35, compared to 65.1% in 1976. With a shrinking share of GDP, normal people will not be in a strong position to stimulate the economy or fully repay their debts and this can have severe consequences for economic stability and social order. The inequitable distribution of income is also exerting pressure on public finances as the state is obliged to support families affected by low incomes.

Tackling income and wealth inequalities is a complex issue, especially as a large amount of wealth is inherited. It requires action on many fronts, including the way the income and wealth created by employees is shared. However, as the next chapter shows, successive government has continued to cling to policies that have already failed to constrain executive pay or secure equitable distribution of income.

34 https://themoneycharity.org.uk/money-statistics/
CHAPTER 4
POLICY FAILURES

Successive governments have done little to check excessive executive pay and failed to reform related policies. They have relied on voluntary codes of corporate governance which have done nothing to check executive pay, secure equitable distribution of income or democratise corporations. Such codes, in any case, are unenforceable in any court of law. In addition, governments have continued to assume that shareholders will somehow constrain executive pay and secure equitable distribution of income. This has not happened.

Voluntary Codes

Since the 1990s, under pressure from corporate elites, governments have relied on voluntary approaches to provide transparency and control of executive remuneration. Corporate governance codes, such as the Cadbury, Greenbury, Hampel and others, provide the framework. The corporate governance codes\(^\text{36}\) assume that corporations exist primarily for the benefit of shareholders and that the levels of remuneration are a matter for elites. Under the codes, quoted companies have been encouraged to appoint remuneration committees consisting of non-executive directors to oversee the amount of executive remuneration. The difficulty is that these non-executives are often directors of other companies or friends of executive directors and have rarely shown an interest in democratising decisions on executive pay or establishing lower benchmarks, especially when they might constrain their own incomes. The government is now extending the same failed codes and policies to other large companies.

The main thrust of executive remuneration practices, legitimised by corporate governance codes, is to align shareholder (other stakeholders are ignored) and executive interests through incentive schemes, often based around the notion of maximising shareholder returns. Company directors are often rewarded in shares and share options and at the same time are permitted under the Companies Acts to expend corporate resources to push-up share prices through share buybacks, excessive dividends and by issuing optimistic earnings forecasts. One consequence of such incentives is that directors are encouraged to take reckless risks, which can increase short-term profits, enrich shareholders and directors but are damaging to taxpayers, employees, suppliers, local communities and society generally. This was evident in the 2007-08 banking crash. The UK’s Banking Standards Commission concluded that “shareholders failed to control risk-taking in banks, and indeed were criticising some for excessive conservatism”\(^\text{37}\). The general ‘comply or explain’ approach in the corporate governance codes is hugely lax. There is no real definition of what would make a satisfactory explanation and regulators have failed to challenge unsatisfactory explanations. More importantly, stakeholders have no enforceable rights. There is no logical reason for excluding executive pay from a legally enforceable framework.


The corporate governance codes have secured some disclosures of executive pay, but the information is poor. Executive remuneration disclosures in annual accounts often understate the pay collected by directors. Many receive perks such as subsidised housing, chauffeur driven cars, the use of private jets, private healthcare, help with house buying and school fees, and these are often poorly accounted for. The use of share options complicates calculation of the value of executive remuneration package and often understates it. Company executives have also been known to fiddle share options by backdating them to maximise their own personal gain.

Since the merger mania of the 1980s and the 1990s, neoliberals have claimed that giving shares and share options to company executives would somehow align shareholder and management interests, which would then lead to improved performance and higher share price in the long term. The banking crash, amongst other examples, and the performance of many companies does not support claims of improved performance. The issue of shares to executives is effectively a wealth transfer from the company and its stakeholders. Executives can increase the value of their shares and share options through wage reductions, cuts in investment, excessive dividends and share buyback operations. The focus on shares and share options has fuelled remuneration inflation and detracts from the long-term issues facing companies and the UK economy.

The Weakness of Shareholder Control

There needs to be an extensive debate about the nature and purpose of a modern corporation. However, one thing is clear: shareholders are not owners of the company. They own shares or part of the capital which gives them controlling rights and the right to receive returns declared by directors, but that does make them owners of the company. On numerous occasions, the courts have stated that a company is a separate legal person and is not a private plaything of shareholders. Numerous studies have shown that shareholders have only a short-term interest in major companies. They do not necessarily bear the residual risks in a company and often contribute only a small fraction of a company’s total capital. For example,

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38 Daily Mail, Fatcats whose perks are worth £11million a year: Business chiefs get cash for jets, schools and even to move house, 18 August 2017 (http://www.dailymail.co.uk/news/article-4803674/Fatcats-perks-worth-11million-year.html).
at major UK banks shareholders provide less than 10% of total capital. Most of the corporate resources are provided by other stakeholders but they rarely have any rights or power to influence corporate governance, distribution of income or executive remuneration.

Successive governments have continued to urge shareholders to act even though they have failed to shackle executive pay or secure equitable distribution of corporate wealth. A major difficulty is that shareholders often have short-term interest in companies and the average shareholding duration has shrunk in the UK and elsewhere (Figure 6).

In the UK, the shareholding duration has fallen from around 5 years in the mid-1960s to around 2 years in the 1980s, down to 7.5 months in 2007, and down to around one month in 2015. With automated computer trading, some shares are only held to 22 seconds. In short, shareholders chase short-term returns and despite occasional protests have shown little interest in checking undeserved executive pay or securing an equitable distribution of income.

In addition to duration, there have also been major changes in share ownership patterns which make it difficult for shareholders to effectively pursue any joint action on executive pay. They rarely know each other to form a common cause. Some may

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43 Prem Sikka and John Stittle, Debunking the Myth of Shareholder Ownership of Companies: Some Implications for Corporate Governance and Financial Reporting, Critical Perspectives on Accounting, forthcoming.

wish to delegate a larger role to institutional investors, but they are not immune to the pressures of short-termism. Their shareholdings in companies have also shrunk and their influence has waned. A large number of FTSE shareholders reside outside the UK and have shown little inclination to check executive pay or secure equitable distribution of income as national problems do not figure on their investment agenda. Figure 7 shows the changes in share ownership patterns⁴⁵.

![UK Share Ownership Patterns](image)

Shareholder power to control executive pay is weak and non-existent for securing an equitable distribution of wealth generated by the co-operative efforts of all stakeholders. Shareholder votes at company general meetings have generally been advisory rather than binding. Historically, the company is not obliged to take any particular course of action based on the outcome of the vote, and no part of a director’s remuneration has been contingent on the vote. It is hard to think of any court case where shareholders have sought to enforce Section 172 of the Companies Act 2006, which requires directors to have regard for the interests of employees, and withhold executive pay or demand a more equitable outcome for employees or consumers or other stakeholders.

Under the pressures generated by scandals, there have been some moves to subject executive remuneration to a binding vote. This has been partly influenced by the EU Shareholder Rights Directive applicable to quoted companies. Article 9a of the revised Directive stated that “Member States shall ensure that shareholders have the right to vote on the remuneration policy as regards directors. Companies shall only pay remuneration to their directors in accordance with a remuneration policy that has been approved by shareholders. The policy shall be submitted for approval by the shareholders at least every three years.”

It should be noted that in the negotiations leading to the Directive, the European Parliament had suggested that “employees” should have a say on executive remuneration before any shareholder vote. However, under pressure from the corporate lobby, the EU Commission dropped this requirement. The Directive nonetheless forms the backdrop to the UK’s Enterprise and Regulatory Reform Act 2013. The Act is accompanied by guidance notes published by the Department of Business Innovation and Skills (BIS).

The key elements of sections 79-82 relating to some aspects of executive remuneration are as follows:

- They apply only to companies listed on the main stock exchanges - AIM listed companies are excluded - and not to all large companies operating in the UK.
- These companies must put the remuneration policy to a shareholder resolution and a binding vote at least every three years.
- They must also produce an annual implementation report on how the approved pay policy has been implemented, including a single figure for the total pay directors received that year.
- Shareholders will also have an annual advisory vote on a resolution to approve the implementation report.
- No individual director’s remuneration is dependent on the resolution on the implementation report being passed as it is an ‘advisory’ resolution.
- All remuneration resolutions are passed by a simple majority. There are no minimum turnout requirements.

These provisions fall far short of the consultation document published by the UK government in 2012 which mentioned:

- an annual binding vote on remuneration policy.
- a requirement that, where a company fails to secure support from 75% of votes cast on the advisory vote on implementation of pay policy, it should issue a

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47 http://www.legislation.gov.uk/ukpga/2013/24/contents/enacted
statement to the market detailing the main issues shareholders have raised and how the company proposes to work with shareholders to address these issues.

Most of these proposals were dropped. The eventual legislation is much closer to the CBI position. The current legislation does not empower stakeholders and even shareholders have a binding vote only once every three years. There is little clear information about executive remuneration and its components or any requirement to disclose the ratio of CEO pay to median employee pay. Nor is there any provision on the composition of remuneration committees or to require employee representation on such committees. As a result there are no employee, or other stakeholder, rights in relation to executive remuneration. The spokespersons for the corporate sector remain opposed to any binding vote for shareholders, or any other stakeholder, on executive remuneration.

Government Going Nowhere

The policies of the current Conservative government are based upon the fiction that corporate governance is primarily a matter for shareholders and that despite their inherent short-termism they will somehow be proactive and curb executive pay. The government proposals do not give employees other long-term stakeholders any voting rights, but state that employees may be consulted and represented by a director even though that person is not elected by employees. There is no mention of any need to establish works councils or consultations with trade unions. The government proposals may appease corporate elites, but token consultation with employees does not provide any enforceable rights and cannot deliver stakeholder accountability or secure equitable distribution of income.

During her campaign to become leader of the Conservative Party and Prime Minister, Theresa May said “If I’m Prime Minister, we’re going to change that system – and we’re going to have not just consumers represented on company boards, but employees as well”, but upon becoming Prime Minister she reneged on her promise to democratise company boards. The government policy for checking executive pay is in disarray.

Its 2016 Green paper on corporate governance reforms, possibly echoing Swedish arrangements, stated that “The way to enable greater shareholder engagement on pay might be to establish a senior Shareholder Committee to scrutinise remuneration and other key corporate issues such as long term strategy and directors’ appointments”. In the face of opposition from corporate elites, the

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51 Theresa May, We can make Britain a country that works for everyone, 11 July 2016; http://press.conservatives.com/post/147947450370/we-can-make-britain-a-country-that-works-for
52 This appears to be modelled on the Swedish concept of a shareholder committee and presupposes that shareholders take a long-term interest in companies.
government quietly abandoned the proposal. The litmus test came at the May 2018 annual general meeting of Royal Bank of Scotland (RBS) where some shareholders tabled a resolution to establish a shareholder committee, in line with the government proposal. The government held 71% of RBS shares and could have voted for the resolution. It did not. The UK Government Investments, a body managing government investment in publicly owned entities, voted against the resolution54.

In August 2017, the government said that it will require quoted companies to report the ratio of CEO pay to the average pay of their UK workforce, along with a narrative explaining changes to that ratio from year to year and setting the ratio in the context of pay and conditions across the wider workforce55. It also favoured naming and shaming directors where 20% of shareholder voted against executive remuneration, a proposal put forward by the Investment Association56, a trade body representing UK investment managers. A register for that purpose is maintained not by any government department but by the Investment Association.

Secondary legislation to require listed companies to report the ratio of CEO pay to the average pay of their UK workforce has been tabled in June 2018. The legislative changes would also require the directors of all large companies to explain how they are acting in the interests of employees and shareholders (this to some extent is already required under Section 172 of the Companies Act 2006).

The naming and shaming register began in late 2017 and has made virtually no difference to executive pay. By June 2018, there were 140 instances of 20% of more of shareholders voting against executive pay. The number of individual director-related resolutions where more than 20% of the votes were against rose from 27 in 2017 to 54 in 2018. None of this prevented fat-cattery or secured a more equitable distribution of income. In 2018, 37% of the shareholders voted against or abstained from approving executive remuneration, but AstraZeneca chief executive still received a remuneration package of £9.4 million. 34.2% of shareholders voted executive pay at BT, but its chief executive still pocketed £2.3 million, including a £1.3 million performance bonus, just weeks after axing 13,000 jobs57. At Royal Mail, 70% of shareholder rejected the executive remuneration policy but it made no difference to the amount collected by the board58. The ‘naming and shaming’ of executive is a blunt tool as shareholders objecting to undeserved executive pay have no sanctions other than selling their shares and that does not address the problem of undeserved executive pay.

54 Prem Sikka, The RBS sell-off can’t hide the Tories’ failure to clean up its rotten culture, Left Foot Forward, 6 June 2018; https://leftfootforward.org/2018/06/the-rbs-sell-off-cant-hide-the-tories-failure-to-clean-up-its-rotten-culture/
56 The public register is available here https://www.theinvestmentassociation.org/publicregister.html
58 Financial Times, Royal Mail suffers 70% shareholder vote against executive pay, 19 July 2018; https://www.ft.com/content/e372d9f0-8b6e-11e8-b18d-0181731a0340
The government worked closely with the Financial Reporting Council (FRC) and a revised voluntary code of corporate governance issued in July 2018\textsuperscript{59}. It advanced ‘comply or explain’, shareholder–centric model of corporate governance, reliance on non-executive directors, a shareholder elected director to represent employees, promise to consider workforce pay rates in setting executive pay and naming and shaming of companies where over 20\% of shareholders vote against executive pay. The Code does not give stakeholders any enforcement rights. It does not even ask executives to ensure that no employee is paid below the statutory minimum wage. The Code has failed to curb excessive executive pay or secure equitable distribution of income.

The next chapter explains the reforms that are necessary for checking undeserved executive pay and also enable employees to secure equitable distribution of income. The proposals also exert pressure on companies to pay attention to the concerns of customers.

CHAPTER 5
RECOMMENDED REFORMS

Reforms need to be guided by principles of fairness, democracy and public accountability. They must constrain the ability of the executives to award themselves disproportionate and undeserved rewards. All wealth is generated by the cooperative efforts of all stakeholders who provide human capital, social capital and finance and should be equitably shared. If company directors think that they deserve more then they must seek approval from all stakeholders, which is unlikely to be granted unless there is a corresponding improvement in benefits for them all. Employees facing wage freezes and stakeholders experiencing poor products, services and high prices are unlikely to approve big rises for executives and thus act as a powerful check on exorbitant pay for directors and spur directors towards a more equitable distribution of income and higher quality of goods/services for stakeholders.

The proposals in this paper would apply to large companies as defined by the Companies Act 2006.

Table 1
Companies Act 2006 Criteria for Company Size

<table>
<thead>
<tr>
<th></th>
<th>Turnover</th>
<th>Balance Sheet Total</th>
<th>Average no. of employees</th>
</tr>
</thead>
<tbody>
<tr>
<td>Micro-entity</td>
<td>Not more than £632,000</td>
<td>Not more than £316,000</td>
<td>Not more than 10</td>
</tr>
<tr>
<td>Small company</td>
<td>Not more than £10.2m</td>
<td>Not more than £5.1m</td>
<td>Not more than 50</td>
</tr>
<tr>
<td>Small group</td>
<td>Not more than £12.2 million OR Not more than £10.2m</td>
<td>Not more than £6.1 million OR Not more than £5.1m</td>
<td>Not more than 50</td>
</tr>
<tr>
<td>Medium-sized company</td>
<td>Not more than £36 million</td>
<td>Not more than £18 million</td>
<td>Not more than 250</td>
</tr>
<tr>
<td>Medium-sized group</td>
<td>Not more than £36 million net OR Not more than £43.2m gross</td>
<td>Not more than £18m net OR Not more than £21.6m gross</td>
<td>Not more than 250</td>
</tr>
<tr>
<td>Large company</td>
<td>£36m or more</td>
<td>£18 million or more</td>
<td>250 or more</td>
</tr>
<tr>
<td>Large group</td>
<td>£36 million net or more OR £43.2 million gross or more</td>
<td>£18m or more OR £21.6 million gross or more</td>
<td>250 or more</td>
</tr>
</tbody>
</table>

The UK has about 5.7 million businesses and the policies proposed here would apply to the 7,285 companies with more than 250 employees which meet the Companies Act 2006 criteria of a large company.

Legislation should be enacted to ensure that the same policies also apply to public bodies, not-for-profit, partnerships, professional associations and other organisations with more than 250 employees.

The proposed reforms are grouped under the following headings:

- those that are best dealt with by codes of practice and disclosure requirements within a statutory framework;
- those that require formal approval by a more representative governance system instituted by legislation; and
- those that may require specific legislative control or prohibition.

**Codes of Practice and Disclosure Requirements**

1. In designing and fixing executive remuneration packages, a company must demonstrate that it has given due regard to the interests of its employees and consumers, and its investment and capital needs.

2. In addition to disclosures in annual reports and websites, executive remuneration contracts in large companies must be publicly available so that stakeholders can have more effective information about the basis and amount of remuneration which is often a complex package of basic salary, other payments and incentives.

3. All executive remuneration contracts must make a clear distinction between the base fixed salary (which can include pension contributions, benefits, etc.) and a variable element related to incentives and targets, which might form part of a long-term incentive plan (LTIP).

The cult of bonus payments to executives needs to be discouraged. Building sustainable companies through higher sales, investment, research and development, job creation, health and safety considerations, customer satisfaction, good relationship with suppliers, control of pollution and care for local communities is all part of good and normal management practices and help to demonstrate that directors have performed their duties with reasonable care, skill and diligence (Section 174, Companies Act 2006). The performance of normal duties should not attract any additional rewards.

Bonuses, if any, are only to be paid for carefully specified and extraordinary performance and must relate to the long-term success of the company. The executive employment contracts must explain the conditions that need to be met and verified by stakeholders for payment of bonuses and the circumstances under which they will be clawed back.

4. The annual report of all large (and medium-size) companies must publish the highest, lowest and median remuneration of all employees (after excluding director pay) on a full-time equivalent basis. This must be analysed by gender and ethnicity.
Companies must state the gender and ethnicity pay gap, the policy for tackling it, the steps taken, change since the last report, and the target.

There must be a requirement to disclose the ratio of total CEO remuneration to median employee pay\textsuperscript{61} and the steps taken to reduce it.

5. Companies must be required to reveal the name and number of employees, analysed by gender and ethnicity, earning more than £150,000 per annum\textsuperscript{62} in brackets of £10,000. The disclosures would help to check the gender pay gap.

6. The government is a major spender and awards numerous contracts. Central and local government authorities must apply a ‘fit and proper’ person test to all suppliers seeking public contracts of £5 million or more. As part of the test, bidders/suppliers must be required to disclose the total number of employees and the proportion, analysed by gender and ethnicity, receiving remuneration of more than £150,000 per annum in brackets of £10,000.

7. Directors must explicitly state in their annual report, that no employee has received remuneration which is less than the National Minimum Wage (NMW) or the Living Wage.

The wilful or persistent failure to pay the legally mandated rate of pay should lead to criminal charges against the company and its board of directors. A minimum fine equivalent to the remuneration of the entire board must be levied\textsuperscript{63} and at least 50% of that should be paid by the directors personally. There is a concern whether the fines are adequate and proportionate for small/medium and large businesses. Linking them to the remuneration of the board resolves that issue.

8. If executives are required to hold company shares they must be purchased with their own resources rather than provided by the company. The purchase, holding and disposal of such shareholdings need to be disclosed.

9. Executive remuneration must be in cash\textsuperscript{64} as rewards in share options, shares and perks invite abuses and complicate the calculation. Shares and share options create temptations to use corporate resources to mount market support. Frequently, share buyback programmes use corporate resources to increase short-term returns to shareholders and the value of share options held by

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\textsuperscript{61} John Lewis Partnership has a pay ratio written into its constitution. No executive can receive more than 75 times average pay. Whether this is acceptable or otherwise is part of a wider debate, but the disclosures give visibility to the issues and facilitate debate.

\textsuperscript{62} Such information is already provided by organisations, such as the BBC.

\textsuperscript{63} There have been 13 successful prosecutions for NMW offences since 2007, with 4 of these in the 2016 calendar year; https://www.parliament.uk/written-questions-answers-statements/written-question/commons/2016-12-20/58353

\textsuperscript{64} The Institute of Business Ethics in its briefing ‘Fair or Unfair? Getting to grips with executive pay’ argues that a greater proportion of executive pay should be made in cash rather than through complex share schemes which make it difficult to establish how much a particular executive is actually paid, 10 February 2016; https://www.ibe.org.uk/userassets/pressreleases/bb3_remuneration.pdf
corporate executives. Such practices deplete resources for investment and are undesirable.

If share options for any reason are to be offered to executives, they must also be offered to all employees on the same terms in quantity and price. All decisions about granting shares and share options would be the responsibility of the company board, or stakeholder board, in the case of two-tier boards, and must be published.

10. Executive remuneration packages must not be changed to compensate executives for changes in their personal tax status.

Statutory Approval Requirements

11. In large companies, all executive remuneration contracts must be formulated by the company board (or stakeholder/supervisory board in the case of two-tier boards). The board(s) must have the full and final responsibility for crafting executive remuneration contracts. It may wish to be advised by a remuneration committee. If such a committee is created it must have representatives of employees and other stakeholders. The composition of such a committee and the mechanism for selection must be published. Its reports must be available to all stakeholders.

Any remuneration advisers used by the company must report directly to the board(s), or a remuneration committee appointed by it. The use and identity of advisers must be disclosed. The consultants' reports and any other advice on executive remuneration obtained by the company to support the level of remuneration package must be filed at Companies House and published on the company's website.

12. The remuneration of each executive at large company must be the subject of an annual binding vote by stakeholders, including shareholders, employees and consumers. Stakeholders must approve the remuneration principles or guidelines for future executive compensation packages in a binding vote on an annual basis.

In the case of utilities, (e.g. gas, water, electricity) and banks, long-term customers/stakeholders (e.g. those transacting with the company for a specified period) can easily be identified with certainty and they must also vote on executive remuneration. Many companies operate loyalty schemes and consumer forums and can easily identify their customers. Thus, consumers in many industries can be identified with certainty and must be empowered to vote on executive pay. This would help to check profiteering, mis-selling of products, poor services and abuses of customers. Consumers receiving poor services are unlikely to approve excessive executive rewards.

65 Stakeholder votes on remuneration are binding in Denmark, Finland, Germany, Japan, the Netherlands, Norway, Sweden, Switzerland and a number of other countries.
Key management personnel named in remuneration reports shall be excluded from casting any votes on executive pay.

Many companies operate a delegated proxy voting system, which is forbidden for trade unions, and this enables named directors to cast thousands of votes and change the outcome of resolutions. This system must be ended. One-person-one-vote is the foundation stone of all democratic practices and must be applied to companies. Directors must be forbidden from casting any proxy votes to skew the outcome of the vote on executive remuneration.

13. The vote on executive remuneration must be in two parts.

(a) The basic remuneration of each executive can be the subject of a simple majority vote by all stakeholders.

(b) The stakeholder ballot for the incentive-based element for each executive must require a two-stage approval.

(i) There needs to be a 50% turnout.

(ii) In addition, there must be support from at least 90% of all voting stakeholders to approve each item of bonus and other incentive-based payments.

14 If 20% of stakeholders vote against remuneration policy or remuneration of any executive then all directors must receive a warning (a yellow-card). This should encourage reflections on executive pay packages and their alignment with the interests of stakeholders. The “first” yellow-card is to be issued when 20% or more of the eligible stakeholders reject the report/proposals on executive remuneration. Following, the first yellow-card, the company’s next remuneration report must explain the Board’s response and the action taken to address stakeholder concerns.

If for the second consecutive year, 20% or more of the eligible stakeholders reject the remuneration report, a second warning (or a red-card) must be issued. This would automatically trigger an additional resolution for the accompanying AGM. This resolution must consider whether the executive and stakeholder directors, with the exception of the managing director and/or chairman, need to stand for re-election. If this resolution is supported by 50% or more of the eligible stakeholders then a meeting to consider re-election of directors must be convened in accordance with the requirements of the Companies Act 2006 or any new provisions that might need to be enacted.

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66 Currently, if 20% or more of the shareholders of a listed company vote against executive remuneration, the company is ‘named and shamed’ by having its name added to a register maintained by the Investment Association. Such arrangements are toothless.

67 This proposal has some similarities to what is popularly known as Australia’s Two-Strike Rule on executive remuneration. For example, see Corporations Amendment (Improving Accountability on Director and Executive Remuneration) Act 2011 (https://www.legislation.gov.au/Details/C2011A00042).
The mechanism outlined above consists of two separate actions. Firstly, there is the need to secure approval from stakeholders. Stakeholders can reject a remuneration package and in addition have a choice of considering changes to the composition of the executive and stakeholder boards, if they so wish. The first course of action does not automatically lead to the second i.e. stakeholders may simply wish the company to redesign the remuneration package. Nevertheless, the possibility that members of the boards might need to be re-elected can restrain executive remuneration policies and focus attention on the welfare of stakeholders.

15 Company law should be changed to give stakeholders the right to fix an upper limit i.e. 'cap' executive remuneration package. This could be in the form of a multiple of pay ratio (e.g. x times the average wage), or an absolute limit (e.g. not exceeding a specified amount) or in any other form that stakeholders see fit.

16 The Companies Act must provide a framework for claw back of executive remuneration. Large companies should have policies and procedures for claw back of remuneration from its current and former executive officers. Circumstances would relate to matters such as fraud, incidences of tax evasion, wilful violation of fiduciary duties, deliberate mis-selling of products/services, publication of false or misleading accounts and profit forecasts. The key idea is to force executives to return rewards which have not been earned by honest economic activity. Full details of the claw back policies must be published in the annual report and included in each executive remuneration contract. The period of claw back should be five years, but unlimited for cases of wilful neglect and fraud. Legislation would be needed to enforce such clawback and to limit any executive discretion to waive it.

Prohibitions and Enforcement

17 Golden handshakes, hellos, handcuffs, parachutes, goodbyes and severance have all become a way of boosting executive remuneration and must be prohibited. Golden handshakes bear no relationship to any notion of performance and are used as a sign-on inducement. They are retained by the executives even though the appointment may turn out to be disastrous. The culture of golden handshakes can encourage a job-hopping mentality and lack of motivation to deliver the long-term welfare of a company. Golden goodbyes are often rewards for dismissed CEOs for poor performance. Payments outside of performance benefit only the executives and not any stakeholder68.

18 In the case of companies with deficits on their employee pension scheme, their directors must not be eligible to receive any bonus or increase in remuneration unless they have reached a binding deficit reduction agreement with the Pensions Regulator.

68Following a 2013 referendum Switzerland has introduced a law (Prohibited Compensation Payments under the Minder Ordinance (VegÜV)) which prohibits the payment of golden handshakes and severance to directors of listed companies. The violation of this law is a criminal offence.
There must be an upper limit on the tax deductibility of total executive remuneration for each member of the board, whether collected from a parent or any subsidiary company. It could be fixed at £1 million per executive, or at any other amount, and the amounts exceeding that should not qualify for tax relief. This proposal does not constrain a company’s ability to remunerate directors for amounts higher than £1 million. The proposal penalises companies that continue to engage in inequitable distribution of income.

A similar cap has existed in the US since 1993. However, the legislation failed to dampen down executive pay because big business persuaded government to insert exceptions. These included incomes from certain employee trusts, annuity plans, pensions, commissions based on individual performance and qualified performance-based compensation. It didn’t take executives and their advisers long to exploit the loopholes and construct their pay packets in the form of stock options, shares and other forms of bonuses to ensure that the entire remuneration package remained tax deductible. It is for these reasons that the above proposal here refers to “total executive remuneration”.

The above recommendations need to be monitored and enforced, but the UK does not have a dedicated regulator responsible for enforcement of company law. Currently, the Financial Reporting Council (FRC), which advocates voluntary approaches through corporate governance code, is responsible for regulation of corporate governance, but does not have any enforcement powers. The FRC sponsored corporate governance codes have failed to check fat-cattery or facilitate an equitable distribution of corporate wealth. Its rules have not given enforceable rights to any stakeholder. The FRC lacks required independence from corporate interests and is unfit to be a regulator. A separate paper, in progress, recommends the creation of a Companies Commission to oversee and enforce UK company law.

CHAPTER 6
CONCLUSION

The reliance on voluntary codes and shareholder-centric model of corporate governance has failed to constrain executive remuneration or secure an equitable distribution of income for employees or better products/services for consumers. Too many executives continue to receive undeserved remuneration.

Rising income inequalities are a threat to social stability and need to be addressed by democratising corporations and giving employees the right to vote on executive pay. Employees facing low wages would not vote for an excessive pay packet for executives. Therefore, executives will need to pay attention to employee welfare and pay levels, or they won’t get their own pay. Established customers should also be empowered to vote on executive pay. Those hit by rip-off prices, unreliable products/services and dud financial products are unlikely to support excessive executive pay. This would exert pressure on companies to pay attention to the concerns of consumers.

This paper has recommended greater disclosures to improve the quality of public information. All too often company boards have ignored public concern about undeserved executive pay. This paper has suggested real sanctions in that a rejection of executive pay by 20% or more of the stakeholders can trigger procedures which might force directors to seek re-election. Such sanctions increase the possibility of alignment between the interests of directors and stakeholders. The government has also been urged to discipline companies indulging in excessive remuneration to executives by restricting tax relief.

Overall, we believe that our proposals would democratise corporations, check undeserved executive remunerations, help to secure equitable distribution of income for employee and address consumer concerns. The proposals would enhance corporate accountability, promote confidence in companies and promote social stability.
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