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Skadden

Executive Compensation and Benefits Alert

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Are UK-Listed Companies Paying the Price for Executive Talent?

Overview

A key factor in recent discussions on revitalising London's place as a capital markets and financial services hub has been a renewed attention on executive compensation. Recent comments made by Julia Hoggett, the CEO of the London Stock Exchange,[1] remarking on the UK's goal to invigorate the UK capital markets, have precipitated further debate among investor groups and in the press on the topic of executive remuneration. This debate is particularly pertinent given the increased focus among London-listed companies in exploring U.S. listings (considered in our April 2023 client alert "Factors for London-Listed Companies To Consider Before Dual Listing or Relisting in the US"), the UK listing regime reforms proposed by the UK Financial Conduct Authority (FCA) (see our May 2023 client alert "UK Listing Rules Reform Proposals — The Dawn of a Lighter Touch Regime in London?") and against the backdrop of decades of calls from investors, politicians and the public alike for restraint and moderation in UK executive pay.

This article analyses the ways in which executive compensation packages might impact companies' decisions in their choices of listing venues, highlighting the extent to which UK and U.S. executive remuneration practices differ and seeking to provide context to the headlines.

Although remuneration packages initially do appear higher in the U.S. than in the UK, the reality is more complex and nuanced than the media portrays. The higher market capitalisations of the largest U.S.-listed companies and different compensation structures and reporting practices in the U.S. mean that headline-grabbing disparities between UK and U.S. executive pay are often exaggerated. The difference in quantum is likely less than it may first appear, and for both executives and companies alike, remuneration will be just one of a number of factors considered in decisions on where to work or list. How the culture and approach in the UK toward executive remuneration will develop remains to be seen as the debate continues in response to Ms Hoggett's comments and broader systemic reforms to the UK capital markets industry.

Are US Executives Paid More?

Looking at the top 10 UK-listed companies and top 10 U.S.-listed companies (each by market capitalisation), the difference in total compensation packages reported for executive directors in 2022 (including salary, bonus and equity awards) appeared to be significant: the

[1] London Stock Exchange Group, "We Need a Constructive Discussion on the UK's Approach to Executive Compensation".

average UK CEO earned approximately US$10.1 million (with the average UK CFO earning approximately US$4.7 million) and the average U.S. CEO earned approximately US$106.6 million (with the average U.S. CFO earning approximately US$28.4 million). Note, however, that the difference in market capitalisation between the largest listed companies in the U.S. and UK is considerable: the average market capitalisation of the top 10 S&P 500 companies (by market capitalisation) is approximately US$1.2 trillion, while the equivalent figure for the top 10 FTSE 100 companies (by market capitalisation) is approximately US$133 billion.[2]

By contrast, comparing the remuneration packages of similarly sized UK- and U.S.-listed companies in similar industries, the divergence is less pronounced. When comparing the FTSE 100 top 10 companies (by market capitalisation) against a group of U.S.-listed companies that (i) are direct competitors of such UK-listed companies and (ii) have a market capitalisation closely aligned to these UK-listed companies, we see less disparity: the average CEO compensation for these U.S.-listed companies in 2022 was almost exactly triple that of the average for the UK-listed companies (approximately US$31 million), and the average U.S. CFO compensation was just under double (approximately US$9.2 million) the values of CFO packages at the comparable UK-listed companies. Despite the difference in executive pay, the comparative variance in the average of these groups of companies' median employee pay was negligible in 2022 — approximately US$100,500 for the UK-listed companies and approximately US$105,600 for their U.S.-listed peers.

These figures suggest that, even when comparing a "like-for-like" (by reference to a company's market capitalisation), U.S.-listed companies pay their executives more than comparable UK-listed companies. We consider in more detail below the potential reasons for the disparity, and how reflective these generalisations are of the extent to which U.S.-listed company executives in fact regularly take home larger pay packages than their UK counterparts do.

Differences in Remuneration Practices and Reporting

Clearly, the larger market capitalisations of U.S.-listed companies are a key driver for higher levels of compensation in U.S.-listed companies as compared to their UK-listed peers. In both the UK and the U.S., larger companies usually pay bigger executive compensation packages. The highest-paid CEO of a FTSE 100 company earned over 50% more in 2022 than the next highest-paid FTSE 100 company CEO because of the first company's growth in market capitalisation. In 2021, this company experienced shareholder dissent against its binding triannual directors' remuneration policy vote (with nearly 40% of voting shareholders voting against it), while at the company's 2023 annual general meeting (AGM), only 5.77% of voting shareholders voted against the company's advisory annual remuneration report vote, suggesting shareholders were willing to reward the CEO for strong company performance, especially in light of reports of recent attempts by U.S.-based competitors to recruit him.

When breaking down the elements of typical UK and U.S. executive compensation packages, the component of the total remuneration package that significantly tips the balance of total remuneration in favour of U.S.-listed company executives is the equity component. The average long-term incentive plan (LTIP) payout in 2022 for CEOs at FTSE's top 10 companies was approximately US$4.5 million, whereas the average LTIP payout for CEOs at top 10 U.S.-listed companies was US$98.2 million and the U.S.-listed competitor group's average was US$23.7 million. Base salaries and bonuses are broadly of similar amounts across the UK and U.S. comparator groups.

Since this element of pay is determined by company performance, it can be argued that the larger U.S. payouts inevitably reflect that the largest U.S.-listed companies have, on a macroeconomic scale, grown more in recent years: on an aggregate basis, the FTSE 100 is down 0.71% in the last five years while the S&P 500 is up 51% for the same period.[3]

In addition, differences in structure for equity awards, practices and reporting potentially contribute to a skewed picture when we look at total compensation figures. For example, when reporting on equity compensation, UK-listed companies disclose (in the single total figure table of their annual directors' remuneration reports) the value of share-based remuneration *vested or exercised* (*i.e.*, received) by each executive during the relevant financial year; conversely in the U.S., the headline figures usually reported relate to equity-based awards *granted* to each executive during the relevant year.[4] Grant figures do not necessarily reflect what the U.S.-listed company's executive eventually legally acquires (for example if the award/option does not vest in full), and press headlines (in both the UK and the U.S.) often do not register this nuance.

The type of award granted, practice for vesting terms and timing for exercise also help shape differences in metrics. For example, in the UK, the most common type of equity award granted by UK-listed companies is a conditional award, which vests (subject to performance) automatically after three years (and so executives receive an equity payout every year (assuming the conditions are met and awards vest at all)), which reflects the

[2] Market data as at 25 May 2023.

[3] Google Finance.

[4] To ensure a meaningful comparison in this article, the U.S. figures referenced have been adjusted to reflect equity awards that vested or share options that were exercised during the relevant year (*i.e.*, the value actually received by the U.S.-listed company's executive, as per the UK equivalent figures).

performance of the shares subject to those equity awards over the previous three years. By comparison, in the U.S., particularly with respect to companies in the technology sector, share options are a common type of long-term incentive award because they allow individuals to participate more in the substantial growth that has often occurred in the sector. Unlike conditional share awards, which are settled in shares automatically on the vesting date, once options vest, the executive typically has a period of time during which he or she may exercise the options, at a time of the executive's choosing (options usually remain exercisable from vesting until ten years post-grant). In practice, this means several years' worth of option grants may be exercised at one time (*e.g.*, on an executive's termination of employment, or when the options are due to lapse), resulting in the executive realising the value of numerous historic equity grants in one year. Some of the large U.S. compensation figures referenced earlier in this article could reflect this fact pattern.

These examples illustrate that headline figures do not tell the full story of compensation, and useful comparisons using statistics alone are difficult to draw out when the pay structures and reporting requirements of each jurisdiction are not always equivalent.

Differences in Investor and Market Sentiments

Comparative Remuneration Policies and Shareholder Dissent

Differences in culture and attitude regarding executive pay also play a key part in transatlantic divergence in remuneration. **In the UK, remuneration-related resolutions are often heavily scrutinised by shareholders and regularly subject to dissenting votes**, often due to the quantum of such packages. In May 2023, for example, nearly 60% of shareholders voting at the AGM of a top 10 FTSE 100 company voted against the advisory directors' remuneration report, largely because the new CEO's base salary (of almost US$1.9 million) was deemed too high. In addition, the percentage of binding remuneration policy votes that were contested in FTSE 100 company AGMs increased from 25% in the 2021 AGM season to 36.4% in the 2022 AGM season, confirming that, of the regular AGM resolutions, these are the most contested. Furthermore, shareholders contested 19.2% of remuneration report resolutions in 2022 (an increase from 12.1% in 2020 and 16.2% in 2021).[5] Although remuneration report votes are only advisory in nature, they receive significant attention in the market (and a vote against a remuneration report can trigger the requirement for a premature policy vote). Remuneration policy shareholder votes (required at least once every three years) are binding, and companies can only make remuneration payments in accordance with the approved policies. **Conversely, in the U.S., no binding remuneration-related shareholder vote requirement exists.**

[5] The Investor Forum, "Thinking Aloud — 2022 AGM Session — Contentious Votes".

CEO-Versus-Employee Pay Ratio Considerations

UK investor sentiment and voting guidance from institutional investors continue to focus on the gulf between the remuneration of the C-suite officers compared to compensation of the remainder of the workforce, and recommends that companies curb executive compensation, especially in the context of the current highly inflationary environment and cost-of-living crisis (as flagged in the Investor Association's most recent Principles of Remuneration report).[6] Overall, UK investors, politicians and media outlets all appear generally more hostile to significant executive payouts than their counterparts in the U.S. are, which culminates in pressure for moderation and restraint by remuneration committees in approaching executive pay packages in the UK and a restriction on the ability of UK-listed companies to pay U.S.-style compensation levels. Interestingly, because the apparent disparity between U.S. and UK levels of executive remuneration does not translate to the general workforce, a greater difference results between UK and U.S. CEO-versus-employee pay ratio figures (an average of approximately 293 to 1 for the U.S. competitor group of companies and 122 to 1 for the FTSE top 10). Notably, UK press and investor groups focus particularly on perceived unfairness and the need to address a widening pay gap, while the larger U.S. ratio rarely receives the same attention in the U.S.

Compensation Related to Additional Leadership Roles and Exceptional Company Growth

Other factors relevant to the pay disparity are sector differences in the two jurisdictions.

- For example the U.S. market comprises more mega-cap and high-growth technology stocks than the UK market does.
- **Also, many U.S.-listed company CEOs additionally serve as the company chair, which may increase their reward packages**, which correlate with the increased litigation risk that comes with acting in such a capacity for a U.S.-listed company.
- In the UK, the UK Corporate Governance Code[7] recommends that separate individuals carry out the chair and CEO roles, with a separate fixed fee being paid to the chair — for example, the median FTSE 30 company chair reported receiving fees of just under US$850,000 in 2022.[8]

Is Compensation the Whole Story?

Although some CEOs have moved from UK-listed companies to U.S.-listed companies and received higher remuneration

[6] The Investment Association, "Principles of Remuneration", 9 November 2022.

[7] Financial Reporting Council, "The UK Corporate Governance Code", 2018.

[8] Willis Towers Watson, "Executive Remuneration in FTSE 100 Companies — 2022 Report".

packages as a result, the UK has been able to retain executive talent, which suggests that headline pay does not paint the full remuneration picture.

Compensation Related to Different Approaches to Termination Notice

Broader employment terms might be a factor. For example, in the UK, executives will typically have the security of notice periods (usually six to 12 months for the most senior executives) prior to termination, whereas U.S. companies base employment agreements on the "employment at will" concept, which means employees can be dismissed immediately without reason. As a result, **employment agreements with severance packages are standard for executives in the U.S., and related payouts are typically higher in the U.S. than in the UK**. Commonly, UK executives will receive payments in lieu of notice by reference to their basic salary only, to enable employers to terminate executives immediately and pay them the amount that they would have otherwise received during their notice periods, or put them on garden leave where they continue to be paid but are unable to move to their next roles for the remainder of the notice period. By contrast, in the U.S., upon executives' termination companies will often pay severance payments and subsidised health and welfare benefits that can equal two or three times the individual's base salary and bonus combined. UK-listed companies are hindered in this regard by investor guidelines and expectations that limit termination notice to 12 months. Payments triggered by a termination also need to align with the company's remuneration policy for directors, which usually limits any *ex gratia* amount that might be awarded in return for a waiver of claims.

Compensation Related to Diverging Non-Compete Terms

In the UK, post-termination restrictive covenants can be no longer and should not extend further in scope than reasonably necessary to protect the employer's legitimate business interests, such as confidential information, customer connection, goodwill and stability of the workforce. The restrictions typically last six to 12 months. Comparatively in the U.S., equivalent restrictions can commonly last up to two years, and the geographic scope/activity of restrictions can often be widely drafted and broad in nature (depending on the applicable governing state law). Meanwhile, the Federal Trade Commission's (FTC's) recent announcement[9] that non-compete agreements should not be enforced and the UK government's proposal in May 2023[10] to limit employment non-compete terms to three months mean that employers in both jurisdictions are probably reconsidering their traditional approaches to post-employment restrictions. In the UK, garden leave is likely to become more significant, and in both countries, making future rewards (for example, entitlement to unvested share awards) conditional upon an executive's future conduct is emerging as an alternative incentive for terminated executives not to compete. UK employers' will need to balance their desire to protect their businesses by extending termination notice (and so garden leave) and the investor scrutiny of notice periods described above.

Compensation Recovery

In the UK, it is a well-established concept that incentive plans provide remuneration committees with discretion to reduce outstanding awards (malus) and recover amounts with respect to vested awards for up to three years post-vesting (clawback) in certain circumstances (typically, material misstatement of results or errors in calculation of performance, serious reputational damage, failure of risk management and corporate failure). Mandatory clawbacks are a relatively new requirement in the U.S., although many companies have historically had broader discretionary policies covering a larger pool of individuals and triggers for clawback.

Conclusion

The impact of executive pay will continue to be viewed as a key factor in ongoing discussions about the UK's competitiveness as a listing venue, alongside the various proposals in the FCA's consultation on the UK Listing Rules. Figures for particular individual pay packages regularly capture headlines, and while the statistics show U.S. pay is higher, the disparity is not as wide as the headlines suggest. Other factors also influence individuals in their decisions about working location and companies in their choices of listing venue. Investor associations will need to reflect on UK cultural and political attitudes regarding executive compensation and the factors that facilitate and drive growth for UK-listed companies (and therefore the value of compensation) in any reconsideration of their approaches to and sentiments on executive pay and as part of the discussion to safeguard vibrant capital markets in the UK. Along with the ongoing systemic reforms to the UK capital markets and financial services industries, challenging investor attitudes and voting behaviour regarding executive compensation in the UK will play a critical part in ensuring that UK-listed companies can compete with their U.S.-listed peers on a level playing field.

[9] U.S. FTC, "Non-Compete Clause Rulemaking", 5 January 2023; *Skadden Insights*, "FTC Proposes Broad Ban on Worker Noncompete Clauses", 9 January 2023.

[10] UK Department for Business & Trade, "Smarter Regulation To Grow the Economy — Reforming Regulations To Reduce Burdens", 10 May 2023.

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