Online Appendix: Not For Publication

Appendix A: Survey Distribution

A.1 Directors

We used Capital IQ and BoardEx to compile a list of non-executive directors of FTSE Premium Listed Companies. We then sought to contact them providing a link to the survey in the following ways:

(a) By email or LinkedIn InMail if the director was known personally to one of the researchers or to London Business School's Advancement Office.

(b) For all others, we used a structured process for guessing emails based on standard corporate email formats and contacted those addresses.

(c) We then identified companies where we had no email address under (a) and where a majority of emails guessed under (b) had bounced back with error messages. For these we worked through the non-executive directors in alphabetical order until we identified a director with a profile on LinkedIn and contacted them via LinkedIn InMail.

(d) The following third parties distributed the survey to their director contacts: The Institute of Directors; The Non-Executive Director Association; and selected remuneration consultants.

Approaches (a) to (c) enabled us to directly contact at least one director at almost all target firms.

A.2 Investors

We adopted a similar approach to investors in our target group, comprising fund managers for UK equity funds listed on TrustNet and signatories to the Stewardship Code. We sought to contact them providing a link to the survey in the following ways:

(a) By email or LinkedIn InMail if the investor was known personally to one of the researchers or to London Business School's Advancement Office.

(b) By email to the lead stewardship contact listed in the firm's stewardship report.

(c) We used a structured process for guessing emails based on standard corporate email formats and contacted those addresses.

(d) The Investment Association distributed the survey to members of its key governance committees.

Appendix B: Corporate Governance and Executive Pay in the UK

This appendix provides additional information on the UK context to supplement Section 3.2. We divide it into three sections: UK corporate governance regulation, further details on UK executive pay regulation, and stylized facts about UK executive pay.

B.1 UK Corporate Governance Regulation

Our survey focuses on non-executive directors of, and institutional investors in, UK Premium Listed companies. These are companies listed on the London Stock Exchange ("LSE") that conform to the most stringent corporate governance requirements.[28]

Corporate governance requirements for UK Premium Listed Companies, including those relating to executive pay, are found in company law (the Companies Act 2006), listing requirements (the Listing Rules), The UK Corporate Governance Code (the Code), and investor guidelines (in particular the Investment Association's Principles of Remuneration). Company law and listing requirements are binding. The Code operates on a comply-or-explain basis, but compliance is very high in areas such as executive pay. Through the Investment Association, investors made it clear that non-compliance would lead to significant opposition; proxy advisor guidelines state that non-compliance will likely

[28] The LSE also has an Alternative Investment Market and a Main List (rather than the Premium List). These follow a less stringent set of rules, particularly in relation to disclosure and approval of executive pay, so their members were not included in our survey.

lead to a "vote against" recommendation. Similarly, while investor guidelines are advisory, they have a significant influence on proxy recommendations and investor voting. Financial firms are subject to additional compulsory corporate governance rules imposed by the main UK regulators, the Prudential Regulatory Authority and the Financial Conduct Authority.

The UK operates a unitary board system, and the Code requires that boards have a majority of independent non-executive directors. In most cases, the only executive directors are the CEO and the CFO, so independent directors are a significant majority. Section 172(1) of the Companies Act requires directors to act in the interest of shareholders, and "in doing so have regard" to other stakeholders.[29] Under the Code, directors are re-elected annually by shareholders.

B.2 UK Executive Pay Regulation

As discussed in Section 3.2, UK companies must submit their remuneration policy to a binding triennial shareholder vote on policy and an annual non-binding vote on the implementation of that policy.[30] While RemCos have wide discretion over the choice of performance metrics and targets used from year to year, the structure and level of pay are more constrained. The policy will typically set out the maximum bonus and long-term incentive, expressed as a multiple of base salary. While the policy might allow for higher amounts to be paid in exceptional circumstances, this leeway is rarely used. So, in practice, the policy stipulates the structure of the CEO pay package (e.g., fixed versus variable, short versus long-term). The remuneration policy contains other design features such as the extent of bonus deferral, deferral and holding periods, shareholding requirements, malus and clawback rules, pension and benefit levels, and notice payments.

[29] Section 172(2) allows for a company to have other purposes than the benefit of shareholders, but such cases are rare.
[30] If the policy vote is lost, the RemCo operates the existing policy until a new policy is approved at a shareholder meeting (typically within a year). Any payment the RemCo wishes to make outside of policy must receive separate binding approval through a shareholder vote, and is therefore exceptionally rare. If the implementation vote is lost, the remuneration policy must be brought back to the following year's shareholder meeting for reapproval via a binding vote, regardless of whether it is due in line with the company's triennial review cycle.

With the structure effectively fixed, the main lever to set pay levels is salary, which typically acts as a reference point for all other package elements (e.g., bonus is set as a multiple of salary). For an incumbent CEO, the policy typically constrains salary increases to be in line with wider employee salary increases or inflation, unless the CEO was an internal hire receiving faster salary increases while she "proves herself." Deviations from these guidelines are possible but rare, and likely to attract significant opposition in the implementation vote. Therefore, through the combination of policy and implementation votes, UK shareholders have a very strong influence on the level and structure of pay for incumbent CEOs. Shareholders are less inclined to intervene on the selection, calibration, and measurement of performance targets in incentive pay, and the policy will generally not constrain boards along these dimensions. However, inappropriate decisions on target setting or evaluation may cause opposition in the non-binding vote.

The Code requires any company receiving more than 20% of opposition in any shareholder vote (including say-on-pay) to issue a statement outlining the actions it will take in response, as well as a follow-up statement on actions taken six months later. The company also appears on the Investment Association's Public Register, to which public stigma is attached. As a result, 80% has become a "soft" approval requirement for say-on-pay votes, in addition to the formal threshold of 50%.

B.3 Stylized Facts on UK CEO Pay

While UK CEO pay differs from company to company, a "typical" pay package for a CEO of a Premium Listed Company comprises the following elements:

(a) A base salary paid in cash, of approximately £1m in the largest companies, falling to £200,000 to £300,000 in smaller companies.

(b) An annual bonus, typically paid two-thirds in cash and one-third in shares deferred for three years. The maximum bonus is up to 200% of salary for a large company and 100% of salary for a smaller one. Targets are based on a mix of financial and non-financial metrics, with the former dominating.

(c) A long-term incentive plan ("LTIP") award made in the form of shares. A portion of the shares vests after three years, subject to meeting performance conditions. Any shares that vest typically have to be held for a further two years. The maximum number of shares might be valued up to 400% of salary for a large company and 100%-150% for a smaller one. Targets are overwhelmingly based on share price and financial metrics, although non-financial metrics do appear in some cases.

(d) Share options are now rare in the UK. There is a nascent trend towards replacing LTIPs with restricted stock – deferred shares with no further performance conditions, other than an underpin to enable a reduction of the award in case of severe underperformance.

(e) Pensions are normally defined contribution, with cash supplements paid where limits on tax-approved pensions are exceeded. In response to the Code, amounts have been declining in recent years and are now trending towards a median of 10% of salary. Other benefits, such as cars and medical and life insurance, remain common.

(f) Shareholding requirements commonly apply, with executives required to hold shares of typically 400% of salary in the largest companies, declining to 100%-200% of salary in smaller ones. Executives are increasingly required to hold these shares for one to two years after leaving the company. FTSE 100 CEOs hold a median of £6.5m of equity in their firms.

(g) Contracts typically provide for 12 months' notice on either side. On termination without notice, an executive can expect to receive a payment in lieu of notice based on salary or salary plus benefits. Bonus and LTIP awards may continue for leavers on a pro-rata basis for the time served if they are 'good leavers'.

Total pay levels are highly dependent on company size. Total realized CEO pay in 2019 for the median FTSE 100 company was £3.5m, failing to £1.5m in the FTSE 250 (companies ranked 101 to 350 by size) and less than £1m for FTSE Small-Cap companies. However, pay increases less rapidly than company size. While median CEO pay is around 0.25% of median market capitalization in the FTSE Small-Cap index, it is below 0.1% for the FTSE 250 and below 0.05% for the FTSE 100.