

A Better Future for Corporate Governance: Democratising Corporations for their Long-Term Success

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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.

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Executive Summary

It is well recognised that the UK economy is not performing to its full potential and economic gains are not being shared equitably. A number of statistics relating to productivity, investment, research and development show that the UK economic performance is lagging behind that of its international competitors. Reports by parliamentary committees, Tomorrow's Company, the Institute for Public Policy Research (IPPR) and the Kay Review, amongst others, have argued that the short-term focus of shareholders and corporate executives is a major reason for the poor performance of the UK economy. The short-term focus (or short-termism) is embedded in the shareholder-centric model prevalent in the UK. The pressures to maintain the share price and appease shareholders, many of whom are short-term investors, have persuaded executives to maintain dividends and other forms of shareholders returns, often at the expense of long-term investment, skills, new products, care for customers, the environment and decent wages for employees. Too many executives collect remuneration packages which are unrelated to corporate performance or the long-term success of the company.

Building a sustainable economy is a major challenge and becomes even more important as the UK needs to meet the challenges of Brexit, artificial intelligence, new technologies and the rise of emerging economies. This requires reforms on a number of fronts, and one of these is to transform the shareholder-centric model of corporate governance into a stakeholder model of corporate governance and focus on partnership between, employees, customers, management and shareholders for long-term success. The stakeholder model of corporate governance is well established in a number of European countries in the form of employee representatives on company boards and has worked well. The presence of employees, long-term shareholders and other stakeholders on company boards has acted as a powerful voice in guiding companies to long-term success. It has checked the power of opportunistic shareholders to force through hostile takeover bids and divestment. It has democratised corporations and delivered higher long-term investment, productivity, growth, research and development, wages and returns to stakeholders, all of which is necessary for building a fair and sustainable economy.

This paper recommends that the next Labour government enact legislation for the mandatory presence of employees, consumers and pension scheme trustees on the boards of all large companies, as defined by the Companies Act 2006. Within a statutory framework, companies should fulfil their obligations by adopting either a unitary or a two-tier board structure. Stakeholder representatives to be directly elected by the relevant constituency and to bring particular perspectives that enable companies to chart a course to long-term success.

The key emphasis is on co-operation amongst long-term stakeholders to secure long-term success of the company. The following is an overview of the proposed reforms:

1. Stakeholders, especially employees, consumers and pension scheme trustees, together with long-term committed shareholders, to be represented on the board of large companies.

2. Companies Act privileges short-termism and the short-term financial interests of shareholders. It must be changed to focus on the long-term and recognise the interest of a broader range of stakeholders by providing them with representation on the boards of directors of large companies. Those stakeholders will be people who have long-term interest in the prosperity and wellbeing of companies, in particular employees and consumers. The rights of shareholders must be changed to shift focus on the long-term rather than short-term speculative gains.
3. Large companies to choose from a unitary or a two-tier board structure to meet their legal obligations.
 - a. A unitary board will have elected representatives of stakeholders, including the employees, customers and long-term shareholders. The stakeholder representatives would occupy specified number of the seats on the board and each will have the rights, powers and responsibilities of an executive director.
 - b. A two-tier board will consist of an executive board and a supervisory/stakeholder board. The supervisory board will have representatives of stakeholders and their role would be to oversee the long-term strategy of the company, including decisions about investment, disinvestment, mergers, takeovers, dividends, pensions, audits and other matters of long-term interest. The executive board will be responsible for the day-to-day operations of the company and its performance will be monitored by the supervisory board. The supervisory board would check short-termism and direct the company towards its long-term success.

The framework for selecting stakeholder representatives to be specified by a new Companies Act.

4. All directors, whether elected by shareholders, employees or consumers, would have identical duties, rights and powers. Their prime duty would be to work for the long-term success of the company for the benefit of all stakeholders, not just shareholders. The concept of the long-term success of the company must include the impact of the company on the rest of society and on the environment, rather than the pursuit of short-term profitability.
5. Directors' duties contained in Section 172 of the Companies Act 2006 should be amended so that shareholder interests are not placed above the interests of other stakeholders. The revised Section 172 could simply state that "A director of a company must act in the way s/he considers, in good faith, would be most likely to promote the success of the company for the benefit of its stakeholders as a whole". Those stakeholders will include the employees, consumers, shareholders, pension scheme members, supply chains and the community more broadly. The revised directors' duties will give recognition to the fact that large companies are public institutions with social obligations.

- 6 The current voluntary code of corporate governance and the 'comply and explain' approach must be replaced with a 'comply or else' approach. Currently, the corporate governance code dealing with governance, remuneration, the audit process and oversight of executive directors, is not legally binding and companies are merely obliged to tell the world whether or not they are complying with the code. Compliance with a revised code within a statutory framework must become obligatory so that stakeholders have enforceable rights to secure accountability of executives and the company.
- 7 The power of short-term shareholders on companies must be constrained. Short-term shareholders hold their shares only for a very short period of time while they seek short-term speculative gains, e.g. through hostile takeovers. The health of the economy requires that companies are operated with long-term objectives. The government must impose a bar on short-term shareholders voting in take-overs and other specified resolutions unless shares have been held by an identifiable owner for at least two years.
- 8 Shareholders to be encouraged to take a long-term view. Those holding shares for two years or more to have double votes.
- 9 An independent Companies Commission to be created to monitor and enforce all aspects of company law and corporate governance.
- 10 The next Labour government to publish a consultation paper on the proposed reforms at the earliest possible opportunity.

The proposed reforms are not a panacea for arresting the deep-seated problems of the British economy. Instead they are necessary steps for releasing companies from short-termism, and freeing them to focus on long-term success.

CHAPTER 1 INTRODUCTION

Corporations dominate all aspects of our lives. Their power affects the quality of food, water, gas, electricity, seas, rivers, environment, schools, hospitals, medicine, news, entertainment, transport, savings, pensions, investments, communications and even the lives of unborn babies. Their turnover exceeds the gross national product of many nation states. Good companies know that their long-term success depends on engagement with their stakeholders, but in pursuit of short-term profits too many roam the world and owe no loyalty to any nation, community or people, and their decisions can undermine and even scupper policies of democratically elected governments. Too many company executives play their selfish games, enriching a few and impoverishing many. Shareholders, employees and consumers are routinely short-changed, sold worthless pensions, endowment mortgages and other financial products. Company boardrooms manufacture diseases, as shown by Thalidomide, Bovine spongiform encephalopathy (BSE), smoking, addictive opiates and diet related diseases, and influence people's life chances. Despite a huge public subsidy, the railway system does not deliver efficient and affordable travel; consumers get unhealthy food and pay excessive prices for gas, electricity, water, medicines, bank overdrafts, credit cards and other goods and services.

Increasingly, large tracts of daily life have been democratised in the form of directly elected political party leaders, trade union leaders, police and crime commissioners and mayors. Voting is not restricted to people of property and wealth, but is recognised as a human right. This right is yet to pass the factory gate and office door. To date citizens, workers and consumers have little direct say in the concentration of huge economic and political power in corporations that profit from their participation, and yet are controlled by a few unelected (virtually unaccountable) executives and dominant shareholders.

There is an urgent need to align corporations with the interests of citizens - employees, consumers, pension scheme members, long term shareholders and others with a long-term interest in the company. Empowering long-term stakeholders is a key requirement for building a sustainable and high value economy. Numerous scandals have highlighted the failures of reliance on voluntary codes of corporate governance, non-executive directors and the shareholder-centric model of corporate governance. Yet the government remains wedded to these failed policies. The task of modernising corporate governance now falls to Labour and it must rise to the challenge.

Chapter 2 provides a brief glimpse of the changes in the British economy. It shows that short-termism has impoverished the country. Chapter 3 argues that Labour needs to build a sustainable economy by challenging short-termism and empowering long-term stakeholders to invigilate and direct companies. Chapter 4 shows that traditional claims about shareholder ownership of companies have little substance and that the focus on increasing short-term returns to shareholders is misguided. Chapter 5 draws attention to some of the consequences of short-termism which are embedded within the shareholder-centric model of corporate governance. The focus on generating short-term returns is damaging the UK economy. Compared to

competitors, UK companies tend to pay out a higher proportion of their earnings in dividends and allocate a lower proportion to investment. The UK lags behind the EU average on investment, gross fixed capital formation and expenditure on research and development. UK employees work for some of the longest hours in the western world, but due to lack of investment it is not translated into higher productivity. The UK productivity levels lag behind its major competitors. Paradoxically, company executives are rewarded for short-term returns and neglecting the long-term. Chapter 6 argues that the shareholder-centric model of corporate governance must be abandoned in favour of a stakeholder model so that attention shifts to generating long-term growth, investment and returns for all stakeholders. The key to building companies for the long-term future is to empower stakeholders with a long-term interest in companies. These are employees, consumers, long-term shareholders (i.e. those who hold shares for at least two years) and others. The chapter calls for the presence of long-term stakeholders on company boards either through a unitary or a two-tier board system. It calls for changes to company law so that a company functions for the welfare of all stakeholders rather than just shareholders. It rejects voluntary codes of corporate governance and calls for legally enforceable frameworks to empower stakeholders. It calls for a newly constituted Companies Commission to enforce all aspects of company law, including the arrangement for good governance. Chapter 7 concludes the paper with a brief summary.

CHAPTER 2 THE CONTEXT

Nearly forty years ago, the 1977 Bullock Report¹ offered an opportunity to put corporations on the long-term path to success by putting elected employee representatives on the boards of large companies. It sought to generate co-operation amongst stakeholders for directing companies towards their long-term success, but instead faced opposition from the left and the right. As a result, the Bullock Report was shelved during the rise of neoliberalism and Thatcherism. Today, the UK, along with Belgium, Bulgaria, Cyprus, Estonia, Italy, Latvia, Lithuania, Malta and Romania are the main European countries without a statutory requirement to have any form of employee representatives on company boards (see Appendix 1). The rest of Europe has embraced the right to include long-term stakeholders on company boards with emphasis on co-operation and inclusion and has reaped benefits in the form of economic stability, higher investment, productivity, growth and wages. The UK too needs to do the same. Since the 1970s, the social and economic landscape has changed beyond all recognition and there is an urgent need to refocus attention on corporate democracy, accountability and long-term success.

Today's Victorian Practices

Today's low wages, zero hour contracts, artificial self-employment of the gig economy and anti-trade union laws have reduced real wages. Employment practices which resemble those of Victorian times have continued. An inquiry by the House of Commons Business, Innovation and Skills Committee found that:

“Workers at Sports Direct were not being paid the national minimum wage, and were being penalised for matters such as taking a short break to drink water and for taking time off work when ill. Some say they were promised permanent contracts in exchange for sexual favours. Serious health and safety breaches also seem to have occurred²”.

A DPD courier died after missing medical appointments because he was under pressure to cover his round and faced the company's £150 daily penalties if he failed to meet his targets³. Balfour Beatty, Carillion, Costain, Kier, Laing O'Rourke, Sir Robert McAlpine, Skanska UK and Vinci maintained secret files on thousands of trade union members⁴. Workers were labelled as follows: “will cause trouble, strong

¹ Bullock Committee, (1977). Report of the Committee on Industrial Democracy, Cmnd 6076, London, HMSO

² House of Commons Business, Innovation and Skills Committee, Employment practices at Sports Direct, London: House of Commons, 2016; https://publications.parliament.uk/pa/cm201617/cmselect/cmbis/219/219.pdf?utm_source=219&utm_medium=module&utm_campaign=modulereports

³ The Guardian, DPD courier who was fined for day off to see doctor dies from diabetes, 5 February 2018; <https://www.theguardian.com/business/2018/feb/05/courier-who-was-fined-for-day-off-to-see-doctor-dies-from-diabetes>

⁴ The matter was eventually settled with out-of-court settlement - see The Guardian, Blacklisted workers win £10m payout from construction firms, 9 May 2016; <https://www.theguardian.com/business/2016/may/09/blacklisted-workers-win-10m-payout-from-construction-firms>

TU [trade union]”, “ex-shop steward, definite problems” and “Irish ex-army, bad egg” with the aim of denying them employment. Despite the statutory requirement, thousands of employees in numerous companies do not receive the national minimum wage⁵. Indeed, employees’ share of GDP has declined from 65.1% in 1976 to 49.14% in 2017⁶, the lowest recorded. Income security in retirement has been eroded as most defined benefit pension schemes have been closed to new staff. The effects of the erosion of people’s purchasing power are evident in the high street as many established companies have gone bust. Such developments are a reminder of the common interests of companies, shareholders and other stakeholders.

Limited liability for shareholders means unlimited liability for the rest

Limited liability for shareholders necessarily confers unlimited liability on others and the rest of society needs to play a key role in directing and invigilating companies. The financial sector, a major supporter of the shareholder-centric model of corporate governance, has been a serial offender and has a history of mis-selling financial products and engaging in tax avoidance, tax evasion, bribery, corruption, money laundering, interest rate and foreign exchange rate rigging and paying hundreds of billions of pounds in fines to the detriment of their stakeholders. The taxpayer funded bailouts in the wake of the 2007/8 banking crisis and the ensuing austerity once again reminded people of the public nature of corporations. The directors of a series of railway operating companies have walked away from their franchises when the contracts did not generate the required rate of return, leaving the taxpayer to pick up the pieces. At Carillion⁷, directors appeased shareholders by paying high dividends, mainly financed by additional borrowing. The company collapsed with £7 billion of liabilities, including a £2.6 billion pension liability. At BHS⁸, directors and shareholders extracted vast amount of cash and then walked away from the pension deficit. It is extremely unlikely that representatives of employees and consumers on company boards would have gone along with any of the above practices.

Short-termism

A McKinsey report⁹ noted that companies with a long-term focus (rather than short-term share price maximisation) deliver higher investment, research and development, growth, employment, financial performance, shareholder returns and

⁵ HMRC, Record 22,400 minimum wage workers to receive millions in backpay, 6 July 2018; <https://www.gov.uk/government/news/record-22400-minimum-wage-workers-to-receive-millions-in-backpay>

⁶ Office for National Statistics, Quarterly national accounts: Quarterly national accounts: January to March 2018, London: ONS, 29 June 2018 (<https://www.ons.gov.uk/economy/grossdomesticproductgdp/bulletins/quarterlynationalaccounts/januarytomarch2018>)

⁷ House of Commons Business, Energy and Industrial Strategy and Work and Pensions Committees, Carillion, London: House of Commons, May 2018.

⁸ House of Commons Business, Energy and Industrial Strategy and Work and Pensions Committees, BHS, London: House of Commons, July 2016.

⁹ McKinsey & Co, Measuring The Economic Impact Of Short-Termism, February 2017; <https://www.mckinsey.com/~media/mckinsey/featured%20insights/Long%20term%20Capitalism/Where%20companies%20with%20a%20long%20term%20view%20outperform%20their%20peers/MGI-Measuring-the-economic-impact-of-short-termism.ashx>

lower earnings volatility. A focus on the long-term is even more important, as the UK faces the challenge of artificial intelligence and new technologies, which requires long-term investment in skills and research. Yet short-termism has been rampant in UK boardrooms. A UK parliamentary inquiry into the 2007-08 banking crash noted that institutional investors were “scarcely alert to the risks to their investments prior to the crash, but were mesmerised by the short-term returns and let down those whose money they were supposed to be safeguarding¹⁰”. The Kay Review noted that there is a “tendency to make decisions in search of immediate gratification at the expense of future returns¹¹”.

There is a broader problem than the short-term shareholding culture: nearly 54% of the shareholders of UK-domiciled companies live outside the UK (Table 1¹²) and have little contact with the corporate products/services and stakeholders.

Table 1
Beneficial ownership of UK shares by value
At 31 December for 2010, 2012, 2014 and 2016

	-----Percent-----				-----£billions-----			
	2010	2012	2014	2016	2010	2012	2014	2016
Rest of the world	43.1	53.3	53.7	53.9	789.5	933.2	1073.6	1100.5
Individuals	10.6	10.6	12.4	12.3	194.6	184.6	247.5	251.5
Unit trusts	8.8	9.5	9.1	9.5	161.9	167.0	181.4	193.7
Other financial institutions	12.3	6.6	7.1	8.1	225.3	114.9	142.5	166.1
Insurance companies	8.8	6.2	5.9	4.9	160.6	108.8	118.3	100.3
Pension funds	5.6	4.7	3.0	3.0	103.3	82.4	60.0	60.6
Public sector	3.0	2.5	2.6	1.1	54.4	44.3	51.8	22.6
Private non-financial	2.2	2.3	2.0	2.2	40.7	40.1	39.2	45.0
Investment trusts	2.1	1.7	1.8	2.1	39.2	30.6	36.0	42.6
Banks	2.5	1.9	1.4	1.8	46.6	33.4	27.8	36.7
Charities, church, etc	0.9	0.6	1.1	1.0	15.6	10.6	22.8	20.7
Total	100.0	100.0	100.0	100.0	1,831.8	1,749.9	2,000.8	2,040.4

¹⁰ UK Parliamentary Commission on Banking Standards, Changing banking for good Vol II, London: House of Lords and House of Commons, 2013; https://www.true-sale-international.com/fileadmin/tsi_downloads/ABS_Research/Finanzmarktstabilisierung/Banking-final-report-vol-ii.pdf

¹¹ John Kay The Kay Review of UK Equity Markets and Long-Term Decision Making, London: UK Department of Business, Innovation and Skills, 2012.

¹² Table as per Office for National Statistics, Ownership of UK quoted shares: 2016, 29 November 2017; <https://www.ons.gov.uk/economy/investmentpensionsandtrusts/bulletins/ownershipofukquotedshares/2016>

Hostile takeovers ratchet up gains for short-term shareholders

Transient global shareholders have left the UK open to hostile takeover bids and resulting asset-stripping and job losses. In 2018 GKN, the UK's third largest engineering group became the subject of a hostile takeover bid by Melrose. GKN was sold with short-term investors, hedge funds and Legal & General, all voting for the hostile bid to secure short-term returns. They secured up to 40% premium on their shares. GKN's 2017 balance sheet showed total assets of £8.9 billion. Shareholders provided only £2.6 billion (or 29%), but enjoyed 100% of the controlling rights. Employees invested their brain, brawn and life in the company, but had no say and were traded as commodities in the takeover bazaars. GKN had a pension deficit of £1.5 billion, but Melrose promised to inject only £1 billion over the next five years. This case is not unique. The 2010 high profile hostile takeover of Cadbury by US based Kraft was facilitated by short-term shareholders who held shares for just a few days. Just a week after promising to keep Cadbury's Somerdale factory, near Bristol open, Kraft backtracked and said it would close the plant. Subsequently, some of the production facilities moved to Poland.

Contrary to free market ideology, shareholders dilute risks and are not disciplined by losses.

At major corporations, such as banks, shareholders provide less than 10% of total capital but continue to enjoy 100% of the controlling rights. The capital structure of Bernard Matthews¹³, Maplin¹⁴, Caffè Nero¹⁵, Toys R Us¹⁶ and other companies shows that shareholders have developed strategies to eliminate the residual risks i.e. they do not rank as unsecured creditors at the end of the queue but through financial engineering have become secured creditors and rank above all others. This means that most of the losses from bankruptcy fall on employees, taxpayers, pension scheme members and supply chain creditors, but these stakeholders have no say in corporate governance and control. Shareholders have always been able to manage risks by diversifying their portfolio of investments and through a combination of call and put options, as options pricing theory has pointed out¹⁷. As risks can be diversified away, too many shareholders have become risk-insensitive and fail to discipline management for excessive risk-taking. In contrast, taxpayers, consumers, pension scheme members, suppliers and employees with company specific skills

¹³ Prem Sikka, Bernard Matthews Limited, Bernard Matthews Holdings Limited and Pension Scheme. London: House of Commons Work and Pensions Committee; <https://www.parliament.uk/documents/commons-committees/work-and-pensions/Bernard-Matthews-administration-arrangement-Prem-Sikka-briefing-05-10-2016.pdf>

¹⁴ Prem Sikka, Revealed: How a private equity takeover contributed to Maplin's demise, 2 March 2018; <https://leftfootforward.org/2018/03/revealed-how-private-equity-contributed-to-maplins-demise/>

¹⁵ Prem Sikka, Here's how Caffè Nero made £2bn in sales but didn't pay a penny in corporation tax, 12 March 2018; <https://leftfootforward.org/2018/03/heres-how-caffe-nero-made-2bn-in-sales-but-did-not-pay-a-penny-in-corporation-tax/>

¹⁶ David Dayen, Toys 'R' Us Workers Take on Private-Equity Barons: 'You Ought to Be Ashamed', 5 June 2018; <https://www.thenation.com/article/toys-r-us-workers-take-private-equity-barons-ashamed/>

¹⁷ Fischer Black and Myron Scholes, The Pricing of Options and Corporate Liabilities, Journal of Political Economy, 81(3): 637-654, 1973.

and knowledge cannot easily diversify away their risks and have to bear the brunt of the cost of corporate failures and malpractices. Employees cannot store their labour and in the event of a corporate collapse stand to lose their jobs, pensions and savings (if held directly or indirectly in company shares). Risk management perspectives alone call for a re-examination of the relationship between corporations and society and empowerment of those bearing the brunt of the risks.

Many of the old assumptions and much of the 'free market' ideology about shareholder ownership and risk-taking no longer apply to today's mega-corporations. Too many shareholders are unable or unwilling to invigilate companies for the benefit of society. Control of large economically and politically powerful corporations is in the hands of a few company executives who increasingly regard companies as their private fiefdoms. In the words of Martin Wolf, chief economics commentator at the Financial Times:

“companies are not effectively owned. That makes them vulnerable to looting. Incentives allegedly provided to align the interests of top employees with those of shareholders, such as share options, create incentives to manipulate corporate earnings, at the expense of the long-term health of the company. Shareholder control is too often an illusion and shareholder value maximisation a snare, or worse”¹⁸.

The shareholder-centric model of corporate governance has become dysfunctional. Companies are being hollowed-out, broken-up, asset stripped and dissolved as their executives fail to focus on the long-term. Out of the 100 companies that formed the FTSE 100 in 1984, only 33 survived in 2014¹⁹. Household names such as Kodak, Ferranti, Psion, Acorn Computers, De Havilland, Marconi, ICL, Polly Peck, Phones4U, Woolworths and MFI have disappeared as their directors neglected the long-term and failed to respond to new technology, need for new employee skills, investment, research, customer demands, products and services. In sharp contrast, in Japan with its emphasis on the long-term and stakeholder co-operation there are more than 20,000 companies that are more than 100 years old, with a handful that are more than 1,000 years old²⁰.

During her campaign to become leader of the Conservative Party and Prime Minister, Theresa May held out the prospect of corporate governance reforms and said “we’re going to have not just consumers represented on company boards, but employees as well²¹”, but soon reneged on her promise. The task for reforming corporate governance now falls to Labour.

¹⁸ Financial Times, Seven ways to fix the system's flaws, 22 January 2012; <https://www.ft.com/content/c80b0d2c-4377-11e1-8489-00144feab49a>

¹⁹ E3M, Who Lives the Longest? Busting the social venture survival myth, 10 February 2014; http://socialbusinessint.com/wp-content/uploads/Who-lives-the-longest_-FINAL-version2.pdf

²⁰ BBC News, Can a company live forever?, 19 January 2012; <https://www.bbc.co.uk/news/business-16611040>

²¹ 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>

CHAPTER 3 LABOUR'S MISSION

The next Labour government needs to build a high value economy which would generate higher wages and returns. It would need to rebuild the UK's manufacturing base, invest in research and development, assets, skills and meet the challenge of artificial intelligence, and new and green technologies. Short-termism has been the biggest obstacle and Labour needs to tackle it on all fronts.

Democratise corporations

There is an urgent need to democratise corporations, redefine their relationship with society and put them on the road to long-term success. Short-termism is best mitigated by empowering employees and customers as they have the long-term interest in the wellbeing of a company. The opportunity to do that and put the British economy on a new footing based on co-operation and stakeholder representation at company boards now falls on the Labour Party. It is an opportunity to join the stakeholder model prevalent in Europe and put companies on the long-term path to success and prosperity.

Recognising and empowering a broader range of stakeholders

The basis of the recommendations in this report is that major corporations should not be treated as the exclusive property of shareholders and therefore under the sole control of executives appointed by shareholders. Nor should those executives be supervised only by hand-picked non-executive directors, effectively appointed by the chairman and other executives. Instead management of these major corporations should be supervised and overseen by boards with representatives of all significant stakeholders – shareholders, employees, consumers, pension scheme trustees and wider national or local communities. Those are the key objectives of the governance reforms that should be delivered by the next Labour government.

Ending 'cosy relationships' and vast remuneration packages

The broader objective of the reforms is to end the short-termism of decisions based largely on *current share prices* and the resulting lack of long term investment. It is also intended to end the cosy relationship between full-time executives and the non-executive directors they appoint and the excessive remuneration packages they all share in.

Society gives companies numerous privileges, including limited liability and has every right to change the rules of corporate governance and to ensure that its broader interests are not side-lined. Employees and consumers are a good proxy for society at large and should have representation on the boards of large companies. They have a key interest in the long-term success of a company. Employees rely on companies for wages, pensions and livelihood. They spend more time at companies than most shareholders and their knowledge and training is vital to organisational success. Customers want reliable products and services. Consumers will not buy a car or washing machine if the company cannot provide spare parts. They will shun

airlines and trains that do not make the required investment in research and development and health and safety. A focus on the long-term necessarily can best be achieved by ensuring that representatives of employees and other stakeholders have real power to affect major strategic decisions on the long-term future of the company.

All too often pension trustees, representing former and present employees, have watched helplessly as companies, such as Carillion and BHS, failed to meet their obligations to pension scheme members. In 2016, FTSE100 companies paid £13.3 billion towards their defined benefit pension schemes, compared with £71.8 billion in payments to shareholders²². The presence of a pensions trustee on the board will bring a different perspective to company decisions and ensure that the interests of shareholders are balanced against the obligations to past and present employees.

European models of corporate governance

Labour needs to emulate models of European corporate governance where the involvement of employees in corporate governance is well established in most European countries²³. There are two broad models that have been successfully operated: the single-tier system combining executive and non-executive functions in one 'unitary board'; and the two-tier system distinguishing between a 'management board' and a 'supervisory board' which has oversight of executives and must confirm the decisions of executives on all major strategic issues. In some countries, such as Austria, Germany and Slovakia the employee representatives take their seats on the supervisory board in the two-tier system. In Norway or Sweden, there is a unitary board structure and employees have seats. In a third group, which includes Croatia, France and Slovenia, companies have a choice of structures. Here, employee representatives sit on the supervisory board where it exists; otherwise they sit on the unitary board. In Finland, representation can be at the supervisory board level or in a single-tier board. In all these cases the legislation for appointing or electing employees is framed by their particular histories and social contexts. Where there is a very high density of trade union membership, as in Sweden, employee board members are usually trade union representatives appointed or elected by trade union members in a company. Elsewhere they are employees elected by the entire workforce often in separate sectional votes (see Appendix 1). In some companies worker directors are appointed on a voluntary basis. The choice between these two systems and their relationship with established structures for collective bargaining is ultimately a matter for local politics.

Building a sustainable economy

Corporate governance reforms are an essential requirement for building a sustainable economy. This will require policies on a number of fronts to:

²² The Guardian, Top UK firms paid five times more in dividends than into pensions, 16 August 2016; <https://www.theguardian.com/money/2016/aug/16/top-uk-firms-paid-five-times-more-in-dividends-than-into-pensions>

²³ Aline Conchon, *Workers' voice in corporate governance: A European Perspective*, TUC/ETUI 2015.

- emphasise the essentially public nature of major corporations and the obligations that follow from that status as governing institutions;
- challenge the underlying problems stemming from the prevailing neo-liberal focus on shareholder value and its impact on current governance structures;
- establish arrangements to ensure that the duties of directors and executives are to manage the enterprise as a going concern for the long-term interests of all stakeholders, including the environment, not just for the benefit of shareholders (many of whom are only interested in short-term, speculative profits);
- develop systems for governance that represent all long-term stakeholders – and take steps to ensure that employees, long-term shareholders, consumers and the public at large are effectively represented on company boards and in decisions on major issues;
- minimise the damage arising from short-term speculation and manipulation in market trading in public quoted shares;
- create an effective enforcement body to ensure compliance with both legal rules and less formal codes of practice.

The thinking behind the above objectives for better corporate governance and how they can be achieved by practical, legal and administrative reforms within a programme of reforms by the next Labour government is explained in the chapters that follow. The need for change is supported by detailed facts and figures on the failure of the current system of corporate governance to generate industrial and commercial investment, to counter the purely short-term financial interests of investors, often based abroad, to prevent the take-over of successful British companies by opportunistic shareholders and predatory hedge funds, to curtail the self-interest of the current executive class and to prevent the abuses of pension schemes by controlling shareholder directors.

A focus on large companies

The policies proposed in this paper should apply to all individual large companies and groups of companies with more than 250 employees, as defined in the Companies Act 2006 (Table 2). This threshold is well established and understood.

Table 2
Companies Act 2006 Criteria for Company Size

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

The UK has about 5.7 million businesses and the policies proposed here would apply to the 7,285 companies²⁴ which have more than 250 employees and meet the criteria of a large company, as defined by the Companies Act 2006. 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.

A major objective of the next Labour Government must be to reform the ways in which large corporations are controlled and governed. This is not just about ensuring that they pay the taxes that other smaller businesses have to and do pay. It is about establishing better rules to ensure that corporations maintain their social responsibility by being managed and governed by and in the interests of employees, consumers and other stakeholders who contribute to, or depend on the long-term success of the enterprise.

²⁴ Department for Businesses, Energy & Industrial Strategy, Business Population Estimates for the UK and Regions 2017, 30 November 2017.

CHAPTER 4

A DEMOCRATIC REGIME FOR LARGE CORPORATIONS

The essential starting point for reform of corporate governance is the recognition that large corporations are not the private property of their shareholders and should not be controlled only by executives and directors in the sole or primary interest of shareholders. The claims of exclusive shareholder ownership and the mantra of maximising shareholder value have promoted the demand for maximum shareholder returns whilst preserving their limited liability. Within this logic, shareholders pressurise and incentivise executives and directors to do whatever it takes – raid pension funds, rip-off customers, avoid taxes, degrade employee pay and conditions, increase share buy-backs, sweat-assets, externalise costs onto the community and environment despite their public relations spinning – to squeeze more profits for shareholders.

Companies enjoy significant legal privileges and immunities: legal status as independent corporate bodies separate from their shareholders with limited liability for all those involved as investors, managers or employees. In return for these privileges, it is reasonable that companies should be subjected to legal rules and regulations to ensure that they operate openly and fairly in the interest of all the stakeholders who make a contribution to their activities and wealth generation. This should involve appropriate public disclosure of all important aspects of their operations; including the taxes they pay, the level of wages they pay to all their employees, their treatment of consumers of their products and their impact on the communities within which they carry on their business. It should also involve appropriate structures to ensure that representatives of long-term stakeholders, not just shareholders, but also employees, consumers and members of local communities, are consulted and involved in major decisions on the current management and future investments by the company. Otherwise, the social license to operate is jeopardized.

The precise legal rules and regulations to govern all these matters will need to be included in a new Companies Act. The underlying point is that large companies, whether in the so-called private, public or mixed public/private sectors, are too important socio-economic institutions to be left under the sole effective control of their managers and shareholders. It is the duty of government to provide structures and standards that ensure a degree of fairness for all stakeholders and to prevent self-interested conduct by shareholders and senior executives that results in adverse impacts on local national and international economies.

Challenging the prevailing neo-liberal focus on shareholder value

A key part of reforms is the need to challenge the prevailing neoliberal conception of the company. Its (misleading) claim is that the company belongs exclusively to its shareholders and that the only proper objective of its directors and executives is to address the concerns of other stakeholders only insofar as it is calculated to maximise shareholder value, and thus to be concerned only to increase the value of

its shares. This claim is frequently buttressed by appeals to ‘agency theory’²⁵, which asserts that company directors and executives are merely the agents of the shareholders, and run the company solely for their benefit.

Shareholders cannot own a company

These conceptions are both legally and economically misleading. Companies Act 2006 does not say that shareholders are the “owners” of a company though they enjoy controlling rights. Directors do not have a statutory duty to maximise shareholder wealth to the exclusion of the interests of other stakeholders. A raft of legal studies have made it clear that shareholders cannot own a company like one can own a pen, pencil or mobile phone, and have very limited rights and virtually no responsibility for corporate malpractices²⁶. Directors are not agents of shareholders and are not bound to comply with instructions from their shareholders. In purely legal terms, it has always been the case that the duties of directors are to promote the long term interests of the company. The judgment in the case of *Gramophone & Typewriter Ltd v Stanley* [1908] 2 KB 89 stated that:

“even a resolution of a numerical majority at a general meeting of the company cannot impose its will upon the directors when the articles have confided to them the control of the company affairs. The directors are not servants to obey directions given by the shareholders as individuals; they are not agents appointed by and bound to serve the shareholders as their principals”.

This established and potentially positive position has been subverted by neoliberal thinkers in both the USA and the UK. In contrast to the court judgements, Milton Friedman, a leading neoliberal of the 1970s claimed that shareholders are “*the owners of the business*” and that the responsibility of corporate executives is to “*conduct the business in accordance with their desires, which generally will be to make as much money as possible while conforming to the basic rules of the society*”.²⁷ In his 1962 book Milton Friedman also asserted that:

*“few trends could so thoroughly undermine the very foundations of our free society than the acceptance by corporate officials of a social responsibility other than to make as much money for their stockholders as possible”.*²⁸

²⁵ Jensen, M. C., and Meckling, W. H., (1976). Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, *Journal of Financial Economics*, October, 3:4, 305-360.

²⁶ For example, see Ireland, Paddy Company Law and the Myth of Shareholder Ownership, *Modern Law Review*, 62(1): 32-57, 1999; Shareholder Primacy and the Distribution of Wealth. *The Modern Law Review*, 68(1): 49-81, 2005; Limited liability, shareholder rights and the problem of corporate irresponsibility, *Cambridge Journal of Economics*, 34(5), 837-856, 2010; Honore, A.M. ‘Ownership’ in A.G.Guest (ed), *Oxford Essays in Jurisprudence*, Oxford: Clarendon Press, 1961.

²⁷ Friedman, M. The Social Responsibility of Business Is to Increase Its Profits, *New York Times Magazine*, 13 September 1970, pp. 32–33, 122–26.

²⁸ Friedman, M. *Capitalism and Freedom*, Chicago: University of Chicago Press, page 133.

Shareholder value is a result, not a strategy

The neoliberal ideology downgrades any notion of stakeholder participation and co-operation. The neoliberal conception of corporation was vigorously promoted by the Thatcher and Reagan governments in the UK and the USA and was buttressed by the view that shareholders would oversee the performance of companies and somehow promote broader social welfare. This utterly ignored the fact that the average shareholding period in companies has declined from about five years in the mid-1960s²⁹ to around two years in the 1980s, and may now be around one month³⁰. The focus on short term shareholder returns neglects impact on other stakeholders and has damaged the economy. Major official reports have rejected the notion that shareholders can be expected to exercise this oversight. The European Commission's analysis of the 2007-2008 banking crash concluded that "*the majority of shareholders are passive and are often only focused on short-term profits*".³¹ In the UK the Parliamentary Banking Standards Commission concluded that "*shareholders failed to control risk-taking in banks, and indeed were criticising some for excessive conservatism*".³² There is evidence to suggest that banks with more shareholder-friendly boards, which are banks that conventional wisdom would have considered to be better governed, fared worse during the banking crisis³³. The focus on short-term shareholder returns has been described by Jack Welch, former CEO of General Electric and considered to be father of the "shareholder value" movement, as "a dumb idea" and added that "shareholder value is a result, not a strategy ... Your main constituencies are your employees, your customers and your products"³⁴. This message has not fully been absorbed by governments and many company boards.

The dangers of the shareholder-centric model are now widely recognised and calls for change have come from diverse quarters. For example, the TUC deputy general secretary has stated that:

"The government needs to be bold and for workers to be put on boards of our companies so workers can have a say on the decisions that affect their

²⁹ Haldane, A.G. Patience and Finance, Speech at Oxford China Business Forum, Beijing, 2 September 2010

(<http://www.bankofengland.co.uk/archive/Documents/historicpubs/speeches/2010/speech445.pdf>).

³⁰ The Daily Telegraph, Thatcher's dream for UK investors has become a nightmare, 17 May 2015 (<http://www.telegraph.co.uk/finance/11610490/Thatchers-dream-for-UK-investors-has-become-a-nightmare.html>).

³¹ European Commission, Green Paper - The EU corporate governance framework (COM(2011) 164 final), Brussels: EU, 2011

(http://ec.europa.eu/internal_market/company/docs/modern/com2011-164_en.pdf).

³² UK Parliamentary Commission on Banking Standards, Changing banking for good (Vols. I - VIII), London: the Stationery Office, 2013.

³³ Andrea Beltratti and René M. Stulz, Working Paper N°. 254/2009: Why did some banks perform better during the credit crisis? A cross-country study of the impact of governance and regulation, European Corporate Governance Institute, 2009; <http://www.hec.unil.ch/documents/seminars/ibf/173.pdf>

³⁴ Financial Times, Welch condemns share price focus, 12 March 2019, <https://www.ft.com/content/294ff1f2-0f27-11de-ba10-0000779fd2ac>

working lives ...If we had workers on boards, would we have seen such reckless behaviour [in the corporate sector]? Would Carillion's managers have treated their staff in such a cavalier fashion ... I don't think so³⁵.

A report by the Institute for Public Policy Research (IPPR) recommended that:

"Britain's poor performance on investment, productivity and inequality stem in part from how – and in whose interest – British companies are governed. Tackling these will require more than tinkering. Instead, a fundamental change in how British companies are governed is needed. A modern economy requires productive, purposeful and long term-oriented companies, founded on a partnership between shareholders, management and workers. Reform of corporate governance should be aimed at achieving this³⁶".

The UK Parliamentary Banking Standards Commission despite being dominated by Conservatives grandees recommended that:

"the Government consult on a proposal to amend Section 172 of the Companies Act 2006 to remove shareholder primacy in respect of banks, requiring directors of banks to ensure the financial safety and soundness of the company ahead of the interests of its members".³⁷

The government ignored the above recommendation. It has persisted with shareholder-centric model of corporate governance and the 2018 revised code of corporate governance issued by the Financial Reporting Council also does the same³⁸. Consequently, neither is able to address short-termism and its impact on productivity and investment.

³⁵ Financial Times, Union leaders renew calls for workers on boards post-Carillion, 27 February 2018; <https://www.ft.com/content/63297f22-1bbd-11e8-956a-43db76e69936>

³⁶ Matthew Lawrence, Corporate Governance Reform: Turning business towards long-term success, London: IPPR, 2017, p 2; <https://www.ippr.org/files/2017-07/cej-cgr-dp-17-07-14.pdf>

³⁷ UK Parliamentary Commission on Banking Standards, 2013, page 344.

³⁸ Financial Reporting Council, The UK Corporate Governance Code, London: FRC, 2018; <https://www.frc.org.uk/getattachment/88bd8c45-50ea-4841-95b0-d2f4f48069a2/2018-UK-Corporate-Governance-Code-FINAL.PDF>

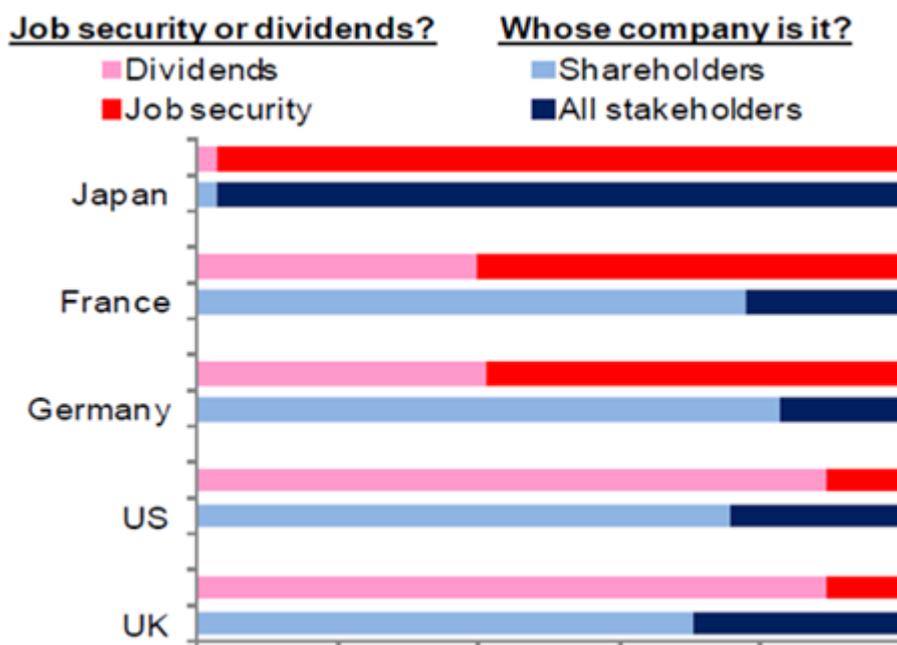
CHAPTER 5 ADVERSE ECONOMIC IMPACTS OF SHORT-TERMISM

The broader culture, institutional arrangements, laws and corporate governance models shape how businesses mediate pressures for shareholder returns and the need to invest in assets and skills for long-term prosperity. The UK's extreme shareholder-centric model of corporate governance has hampered economic development as comparisons with countries with more pluralistic models show.

Short-termism is normalised

In a survey³⁹, senior executives of large companies in UK, US, Japan, Germany and France were asked "Whose company is it?", and a large majority, with the exception of Japan, viewed shareholders, rather than stakeholders, as the ultimate owners. A different pattern of responses emerged when asked about the relative importance of job security for employees versus dividends for shareholders. A majority of Japanese, German and French company executives put employee job security above shareholder dividends. For UK and US companies, a strong majority placed the balance the other way around. 89.3% of the UK executives prioritised shareholder dividends over job security for employees. The results show differences in managerial objectives, incentives and rewards. The survey results are summarised in Figure 1.

Figure 1



³⁹ Masaru Yoshimori, *Whose Company Is It? The Concept of the Corporation in Japan and the West*, *Long Range Planning*, 28(4): 32-44, 1995; Chart from Haldane, A.G., *Who Owns a Company?* Speech at the University of Edinburgh Corporate Finance Conference, 22 May 2015; <https://www.bis.org/review/r150811a.pdf>

Short-term returns are hollowing out companies

Shareholder primacy and pressure on directors to maintain share price has resulted in a significant increase in the proportion of available resources spent on maintaining or increasing shareholder returns in the form of share buybacks and dividends. Andrew Haldane, the Bank of England's Chief Economist, has recently reported that:

*“among UK companies, share buybacks have consistently exceeded share issuance over the past decade ... In other words, over the past decade the equity market no longer appears to have been a source of net new financing to the UK corporate sector”.*⁴⁰

In 1970, major UK companies paid out about £10 of each £100 of profits in dividends, but by 2015 the amount was between £60 and £70, often accompanied by a squeeze on labour and investment. Haldane went on to say that:

“In the earlier period dividends decreased as often as they increased. This is as we would expect as profits fluctuate both up and down. After 1980, however, we see a one-way street. Dividend pay-out ratios almost never fall. This is evidence that the short-term quest for smoothing shareholders returns has come to dominate pay-out behaviour almost irrespective of profitability.”

Amongst developed countries, the UK pays out the highest proportion of corporate earnings in dividends (Figure 2⁴¹)

Figure 2



⁴⁰ Haldane, A.G., Who Owns a Company? Speech at the University of Edinburgh Corporate Finance Conference, 22 May 2015; <https://www.bis.org/review/r150811a.pdf>

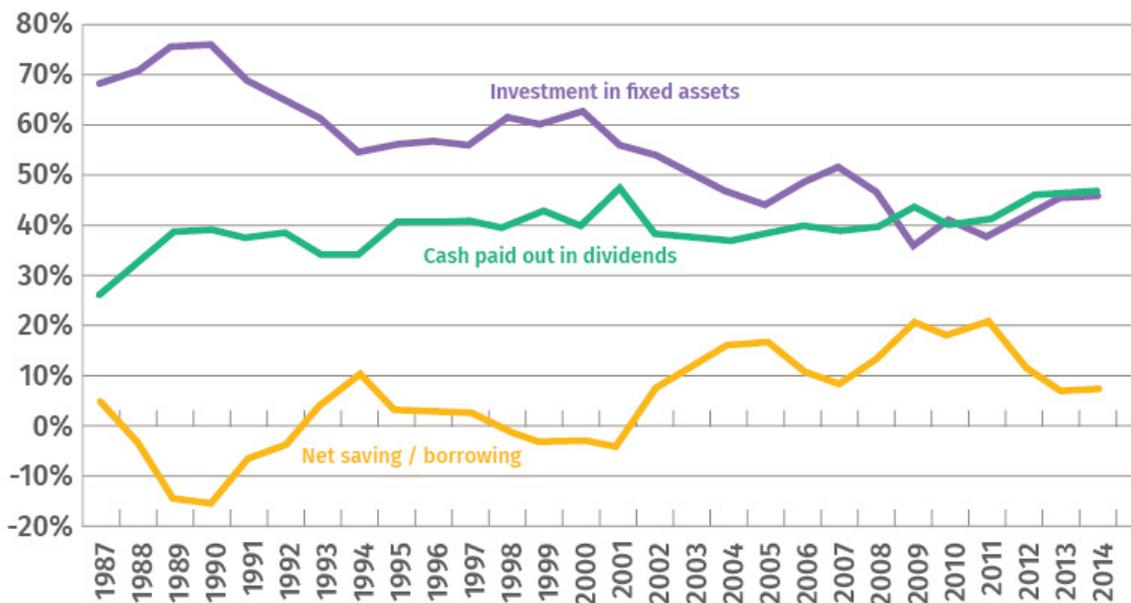
⁴¹ Figure from Flip Chart Fairy Tales, Corporate governance and short-termism, 9 February 2018; <https://flipchartfairytales.wordpress.com/2018/02/09/corporate-governance-and-short-termism/>

Despite the recession, in 2017, FTSE 100 companies' dividends soared to £94 billion and the companies spent another £15 billion on share buybacks⁴². Maintaining dividends at almost any cost has become a board priority. For example, in the decade to 2016, water companies declared post-tax profits of £18.8 billion and paid £18.1 billion in dividends, whilst millions of gallons of water leaked from supply pipes and customers faced hefty increases in charges⁴³. The concentration on short-term returns to shareholders has not protected companies from foreign or hostile takeovers. The concentration on short-term share price movements has also exposed major companies to market movements or manipulation by speculators who are interested only in profits from share trading rather than the long-term success or survival of the companies.

Investment is sacrificed

Investment is the inevitable casualty as companies feel compelled to maintain and increase dividends to shareholders. Figure 3 shows that companies have responded to short-termism by prioritising dividend payments over investment in assets⁴⁴.

Figure 3
Proportion (%) of UK non-financial corporation cash flow allocated to investment, dividends and saving, 1987-2014



⁴² Financial Times, UK share buybacks accelerate as market lags behind, 16 March 2018; <https://www.ft.com/content/df9bad78-2770-11e8-b27e-cc62a39d57a0>

⁴³ Mail on Sunday, Fury at United Utilities as it pays £180m dividend while planning to impose a hosepipe ban on customers, 22 July 2018; <http://www.thisismoney.co.uk/money/news/article-5977987/United-Utilities-pays-180m-dividend-Experts-say-plug-leaks-rewarding-investors.html>

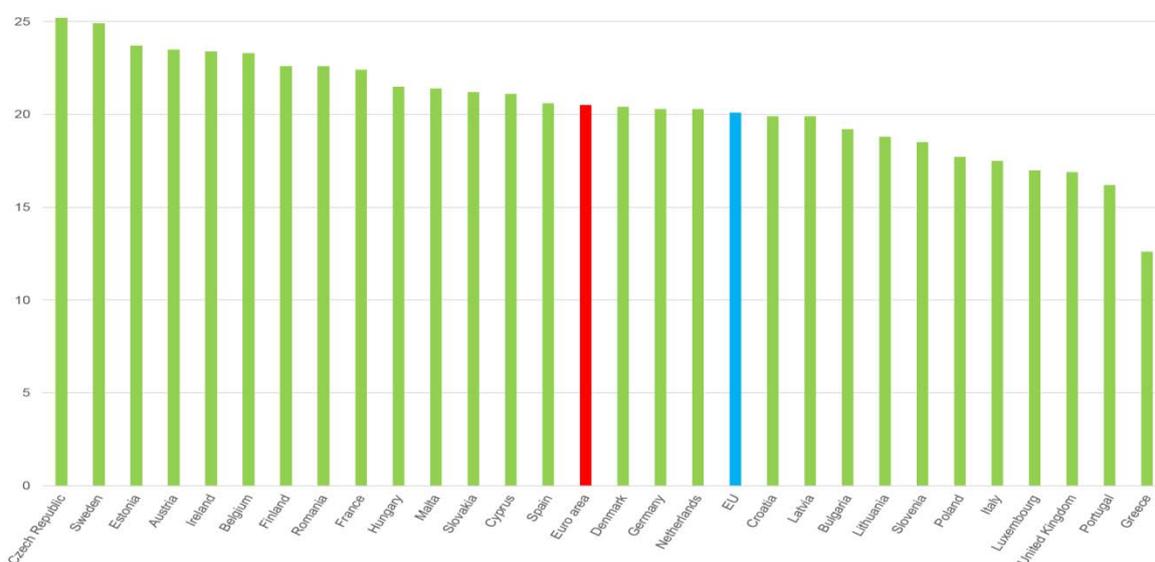
⁴⁴ Tomorrow's Company (2016) UK Business: What's Wrong? What's Next?, Tomorrow's Company. <http://tomorrowcompany.com/wp-content/uploads/2016/05/UK-Business-Whats-wrong-Whats-next.pdf>; Matthew Lawrence, Corporate Governance Reform: Turning business towards long-term success, London: IPPR, 2017, <https://www.ippr.org/files/2017-07/cej-cgr-dp-17-07-14.pdf>

A Bank of England survey showed that only around 25 per cent of finance raised by companies is spent on investment, with the remainder split between purchasing financial assets, distributing to shareholders and keeping as cash⁴⁵. The Bank of England reported that:

“80% of publicly listed businesses that underinvested answered yes when asked if financial market pressures for short-term returns were an obstacle to investment. 40% of privately owned businesses also answered yes. While it may be surprising that private businesses, that do not have shareholders to pay out to, were also affected by this factor, our interpretation is that this reflects the broader macroeconomic environment of impatience that favours returns today over the equivalent value of returns tomorrow. Indeed, companies owned by private equity or venture capital funds may also have owners who are incentivised to realise shorter-term returns. Family-owned businesses may also be keen to ensure that any rates of return from investment are matched to the returns that they can gain by deploying the money elsewhere, such as through investments in financial market⁴⁶”.

The UK culture of short-termism has resulted in lower investment in comparison to major EU competitors.

Figure 4
Investment levels by EU Member States, 2017
(as % of GDP)



ec.europa.eu/eurostat

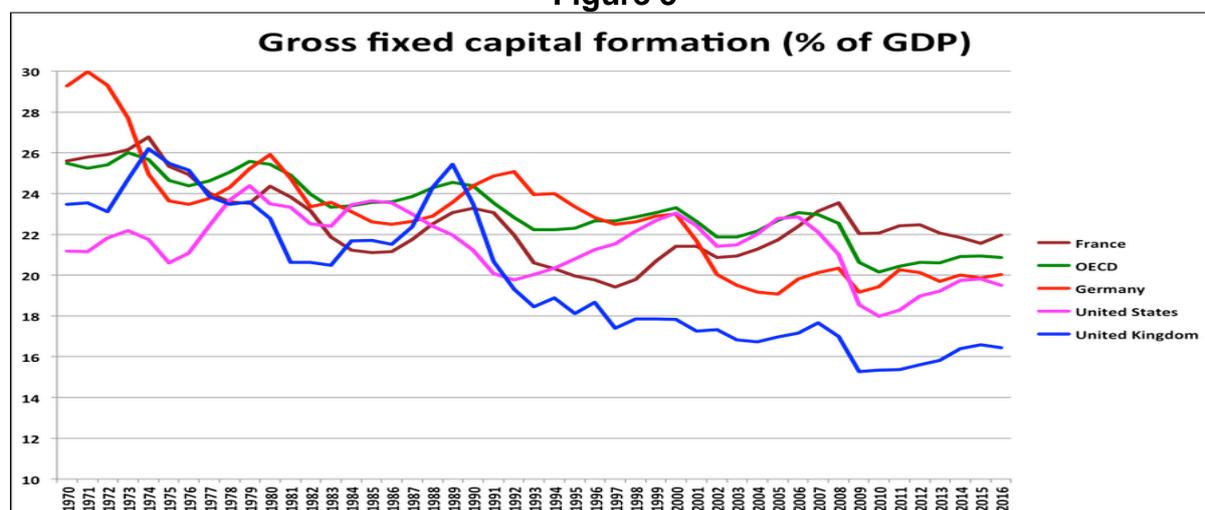
⁴⁵ Matthew Lawrence, Corporate Governance Reform: Turning business towards long-term success, London: IPPR, 2017, <https://www.ippr.org/files/2017-07/cej-cgr-dp-17-07-14.pdf>, p.6

⁴⁶ Bank of England, Quarterly Bulletin 2017, Q1: The financial system and productive investment: new survey evidence, p.12 <https://www.bankofengland.co.uk/-/media/boe/files/quarterly-bulletin/2017/the-financial-system-and-productive-investment-new-survey-evidence.pdf?la=en&hash=C4233339B2ABA202BF328EDDAF631C6AA5458E2B>

On average, in 2017, EU countries put 20.1% of their GDP into long-term investment (Figure 4). Czech Republic (25.2%), Sweden (24.9%), Estonia (23.7%), Austria (23.5%), Ireland (23.4%), Belgium (23.3%), Romania and Finland (both 22.6%) as well as France (22.4%) all had investment rates of over 20% of GDP. At the opposite end of the scale, the lowest ratio of investment to GDP was recorded by Greece (12.6%), followed by Portugal (16.2%) and the United Kingdom (16.9%)⁴⁷.

For economic renaissance, countries need to invest in the stock of productive assets. The gross fixed capital formation (GFCF) measures the net increase in fixed capital, and again the UK lags behind its major competitors. The Office for National Statistics reported that over the 20-year period from 1997 to 2017, the UK has had an average value of 16.7% of GDP being accounted for by its gross fixed capital formation, the lowest amongst developed economies⁴⁸. The UK GFCF has been in decline, particularly in relation to France and Germany, since the early 1990s, a period that coincided with the promotion of corporate governance codes and pursuit of shareholder value (Figure 5⁴⁹).

Figure 5



Short-termism does not bode well for renaissance of the UK manufacturing industry, which needs long-term focus on research and development (R&D) as there is a considerable time lag between investment, product development and sales. Manufacturing accounts for over 30% of GDP in China, 20% of GDP in Germany, 12% in the US, 19% in Japan and 9% in the UK.

⁴⁷ Eurostat How much does your country invest? 14 May 2018, <http://ec.europa.eu/eurostat/web/products-eurostat-news/-/DDN-20180514-1>

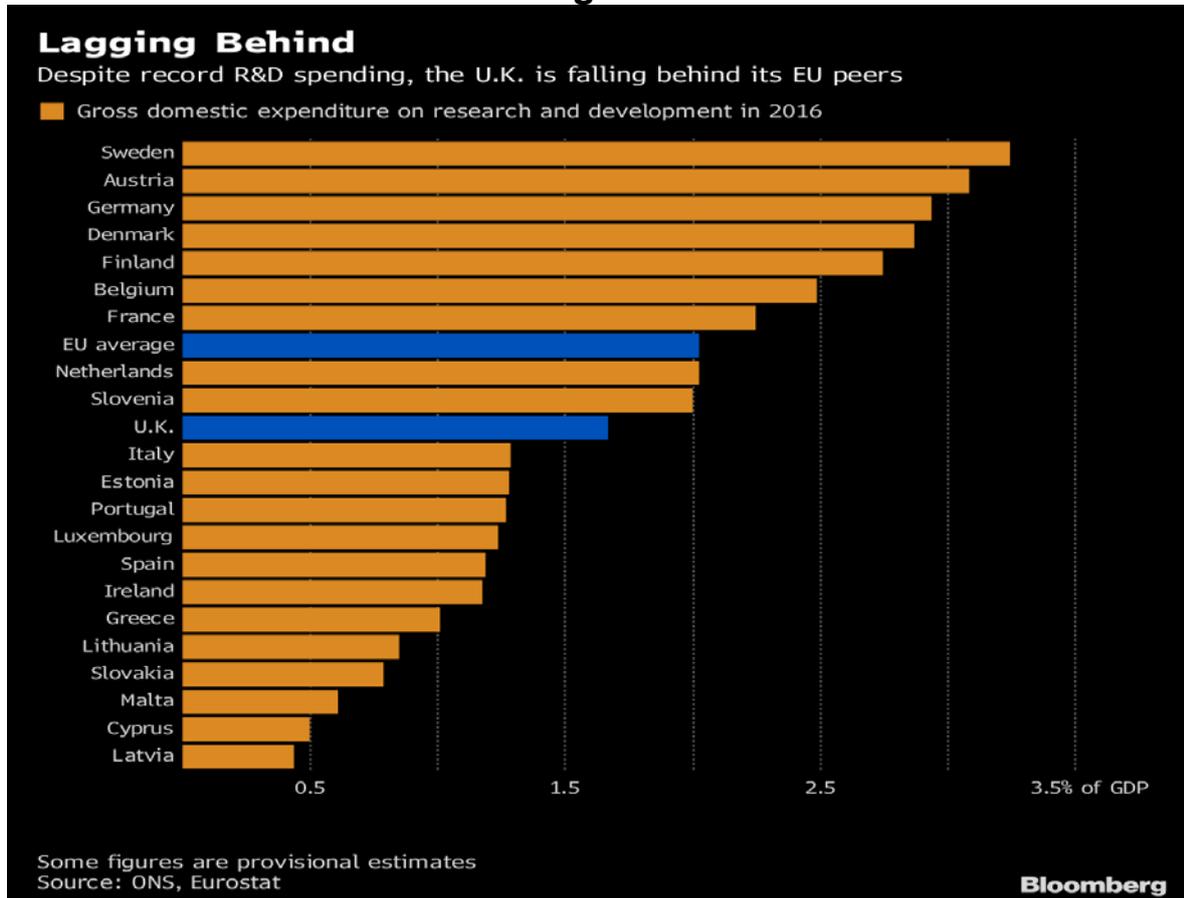
⁴⁸ Office for National Statistics, An international comparison of gross fixed capital formation, November 2017; <https://www.ons.gov.uk/economy/grossdomesticproductgdp/articles/aninternationalcomparisonofgrossfixedcapitalformation/2017-11-02>

⁴⁹ Figure from Flip Chart Fairy Tales, Corporate governance and short-termism, 9 February 2018; <https://flipchartfairytales.wordpress.com/2018/02/09/corporate-governance-and-short-termism/>

Trailing in research and development

Since the 1990s, the UK R&D expenditure has fluctuated between 1.53% and 1.67% of GDP⁵⁰. It lags behind the EU average and R&D expenditure by major international competitors, most of whom have pluralist corporate governance structures (Figure 6⁵¹).

Figure 6



In recent decades the UK has focused on financial services while much of the manufacturing is owned from abroad e.g. the UK car industry is mainly owned by Japanese, German and Indian firms. Foreign owned businesses account for over 50% of the R&D expenditure. The level of R&D expenditure is vulnerable to decisions made in other countries and domestic manufacturers continue to be hampered by short-termism.

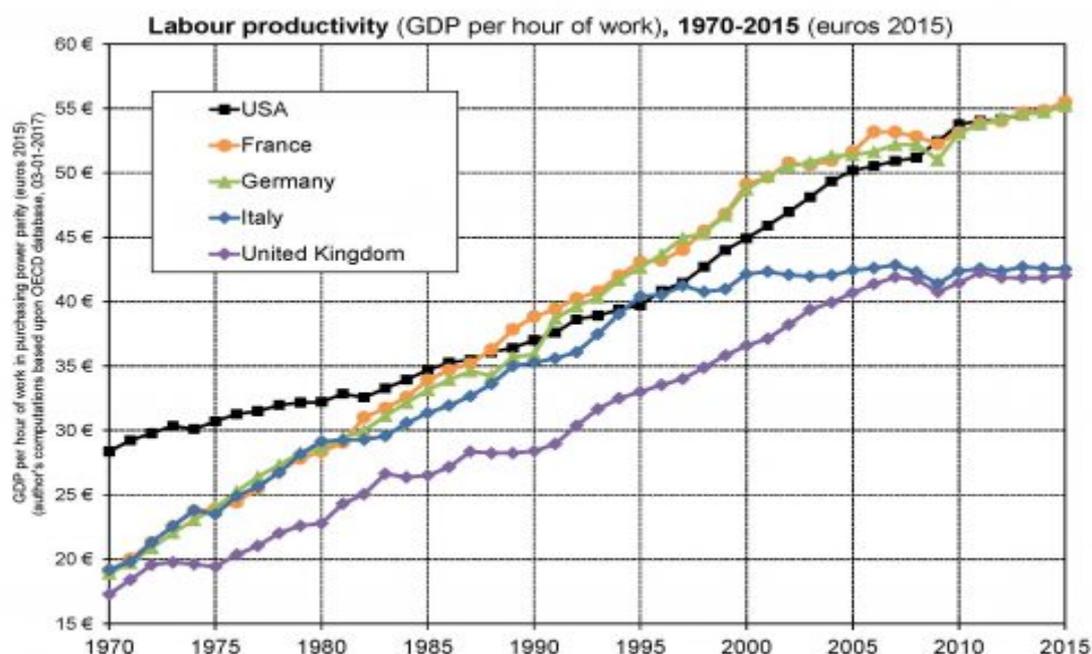
⁵⁰ Office for National Statistics, Gross domestic expenditure on research and development, UK: 2016; March 2018; <https://www.ons.gov.uk/economy/governmentpublicsectorandtaxes/researchanddevelopment/expenditure/bulletins/ukgrossdomesticexpenditureonresearchanddevelopment/2016>

⁵¹ Source: Bloomberg, Productivity-Poor U.K. Lags EU on Research and Development, 15 March 2018; <https://www.bloomberg.com/news/articles/2018-03-15/productivity-poor-u-k-lags-eu-on-research-and-development>

Productivity Suffers

Short-termism and the accompanying squeeze on investment in productive assets and research and development has manifested itself in low productivity rates. British employees, subjected to a shareholder-centric model of corporate governance, work for longer hours each year than their counterparts in Austria, Denmark, Finland, France, Germany, Luxembourg, Netherlands, Norway and Sweden, all with a statutory requirement to have employees on company boards⁵². The official UK estimates are that the output per hour worked in the UK is about 16% below the average for the rest of the G7 advanced economies⁵³. The UK productivity is around 27% below that of Germany⁵⁴ as the UK makes a smaller investment in assets, research and development and staff upskilling. Some international comparisons are shown in Figure 7⁵⁵. Once again, despite working shorter hours, Germany and France with more pluralistic forms of corporate governance out-perform the UK

Figure 7



⁵² The Telegraph, Which nationalities work the longest hours? 7 February 2018; <https://www.telegraph.co.uk/travel/maps-and-graphics/nationalities-that-work-the-longest-hours/>

⁵³ Office for National Statistics, International comparisons of UK productivity (ICP), final estimates: 2016, 6 April 2018; <https://www.ons.gov.uk/economy/economicoutputandproductivity/productivitymeasures/bulletins/internationalcomparisonsofproductivityfinalestimates/2016>

⁵⁴ The Independent, UK workers are 27% less productive than German counterparts, say British business leaders, 11 July 2017; <https://www.independent.co.uk/news/business/news/uk-workers-less-productive-germany-business-france-american-sir-charlie-mayfield-john-lewis-be-the-a7834921.html>

⁵⁵ Source – Thomas Piketty, Of productivity in France and in Germany, 9 January 2017; <http://piketty.blog.lemonde.fr/2017/01/09/of-productivity-in-france-and-in-germany/>

Long-term damage to the UK economy

A vibrant manufacturing sector is essential for the development of a sustainable economy. It reduces over-reliance on the financial sector, which has been prone to a series of crises since the 1970s. Many jobs in the service sector, e.g. hospitality, restaurants, are poorly paid and therefore the need to develop a strong manufacturing sector with well-paid skilled and semi-skilled jobs is even greater. A strong manufacturing economy is also necessary for addressing persistent balance of payment problems.

With the rise of new technologies and emerging economies, every economy has gone through change, but the decline in the manufacturing base is deeper and more sustained than that experienced in France and Germany⁵⁶. The data presented above shows that the UK lags behind its major competitors, mostly with pluralist corporate governance structures, in investment, R&D expenditure and productivity, though it leads on short-term returns and cash extraction to appease shareholders.

The negative impact of the UK corporate governance model on innovation and manufacturing is explicitly recognised in a UK government report in 2013:

“the existing corporate governance framework operating in the UK, which generally favours shareholders, acts negatively on innovation, with particularly unfavourable impact on manufacturing. On balance, it is possible to argue that the current legal framework in the UK is a deterrent to (manufacturing) firms’ undertaking complementary investments in knowledge-based technologies and firm-specific human capital, given that both generate returns over an extended period”⁵⁷

The report concluded that

“An emphasis on short term returns by investors’ leads to management focus on short term movements in stock market prices, and the threat of takeover, with long term investment in new capital equipment, skills and training and R&D spend inhibited. These effects are damaging for manufacturing, which requires relatively high long term investment in terms of new capital equipment, R&D and skills. The institutional architecture which encourages impatience in corporate governance and the capital market must be addressed to support future UK manufacturing competitiveness⁵⁸”.

⁵⁶ UNITE, Productivity – A Comparison in Manufacturing: UK, France, Germany & USA, 2015;
<http://www.unitetheunion.org/uploaded/documents/Comparison%20In%20Manufacturing%20Booklet11-25509.pdf>

⁵⁷ UK Government Office for Science, The future of manufacturing: A new era of opportunity and challenge for the UK, 2013, p. 142;
https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/255922/13-809-future-manufacturing-project-report.pdf

⁵⁸ UK Government Office for Science, the future of manufacturing, 2013, *ibid*, p. 25.

The government has failed to advance any effective reforms and short-termism paradoxically results in greater rewards for company executives.

Rewards of short-termism

The focus on shareholder value has also had an impact on the way in which senior directors and executives are paid. There has been a major increase in recent decades on remuneration packages which include substantial share options or share allocations. The underlying idea is that if directors and executives can be encouraged to think of themselves as sharing the interests of shareholders they will be more likely to focus on maximising the value of their shares. The actual impact has been to divert them from concentrating on the long term development of the productive business of their companies and to focus their attention on the shorter term share price movements on which their personal income will depend. In simpler terms, it has increased the influence on company boards of the market in shares at the expense of productive development and investment.

A recent study⁵⁹ on executive pay packages in comparison with the average increase in employee pay concluded that many managers are grossly overpaid and that this has not had any beneficial effect on the efficiency or profitability of their companies (Table 3).

<u>Year</u>	<u>CEO total realised</u>	<u>Average employee pay</u>	<u>Ratio</u>
2009	£4,932,954	£32,521	152
2010	£4,518,812	£34,176	132
2011	£4,200,000	£35,744	118
2012	£4,193,395	£36,672	114
2013	£4,323,221	£34,482	125
2014	£5,212,415	£34,846	150
2016	£4.53m	not stated	138

Source: High Pay Centre, Pay Ratios: Just Do It, 2015 & CIPD/HPC 2016 Survey

Short-termism and the squeeze on labour have contributed to increasing social and economic inequality as company executives have appropriated disproportionate rewards as indicated by the table above. That in itself is increasingly regarded as an unjustifiable and unacceptable aspect of the UK corporate governance model. Such consequences are not inevitable and can best be controlled by empowering long-term stakeholders through seats on company boards. The pressure to appease shareholders has also eroded the purchasing power of employees. In 1976, the proportion of GDP going to employees (including bankers and company executives) in the form of wages and salaries was 65.1%; by 2017 it declined to 49.14% of

⁵⁹ Max Steuer, Peter Abell and Henry Wynn, Head-hunter methods for CEO selection, Journal of General Management, 41(1): 3-24, 2015.

GDP⁶⁰. This is almost the lowest ever recorded, and is a major contributor to the UK's sustained economic downturn.

Renewal of corporate governance

The preceding analysis has identified a number of problems with the UK economy and they are related to the prevalence of short-termism⁶¹, which itself is incubated by the shareholder-centric model of corporate governance⁶². Its damaging effects can be summarised as follows:

- Too many corporate decisions are often taken on the basis of short-term movements in share prices and short-term returns to shareholders rather than longer term investment in the business.
- The value of director remuneration packages, shares and share options is influenced by short-term share prices and returns and this encourages neglect of the long-term.
- Weak non-executive directors within unitary boards are too close and dependent upon executive directors and are unable or unwilling to hold executive directors to account.
- Shareholders are now predominantly foreign based⁶³ and are mainly focused on short-term returns. They have little contact with corporate products, services, employees or other stakeholders and have little or no inclination to invigilate companies for the long-term.
- Shareholding duration by UK individuals has declined and shareholders are focused on short term returns, and less on long-term strategic issues.
- A series of voluntary codes of conduct on corporate governance claim to promote good practice but have failed to secure good governance or enabled the UK to arrest its economic decline. The codes have no structure for external adjudication or sanctions for non-compliance other than an obligation to 'comply or explain'. The claims in these codes about shareholder ownership, control and invigilation have little substance as there is little focus on the long-term.

⁶⁰ Office for National Statistics, Quarterly national accounts: Quarterly national accounts: January to March 2018, London: ONS, 29 June 2018 (<https://www.ons.gov.uk/economy/grossdomesticproductgdp/bulletins/quarterlynationalaccounts/januarytomarch2018>)

⁶¹ Short-termism has also been identified as a key problem in earlier Labour reviews – for example see, Sir George Cox, *Overcoming Short-termism within British Business: The key to sustained economic growth*, 2013; https://www.policyforum.labour.org.uk/uploads/editor/files/Overcoming_Short-termism.pdf

⁶² Such an analysis is also shared by others. For example, see Janet Williamson, Ciaran Driver and Peter Kenway, *Beyond Shareholder Value: The reasons and choices for corporate governance reform*, London: TUC, 2014.

⁶³ Office for National Statistics, *Ownership of UK quoted shares: 2016*, 29 November 2017; <https://www.ons.gov.uk/economy/investmentpensionsandtrusts/bulletins/ownershipofukquotedshares/2016>

A reform of corporate governance for the benefit of the entire society is long overdue.

The response to these weaknesses will require the replacement of the 'maximizing shareholder value' mantra by an approach that reflects and appreciates the contribution of diverse stakeholders in the long-term development of corporate businesses. For large companies the following measures will be essential for improved corporate governance and for better economic performance:

- The restatement of the duty of directors to promote the long-term future of the company for the benefit of all its stakeholders.
- The involvement of employees and other key stakeholders in corporate boards whether with specified powers within a unitary board or by a move to two-tier board structures. Clearly defined and separated roles for executive day-to-day managers and for all stakeholder representatives on longer-term strategic decisions on investment and take-over and merger activity.
- Measures to ensure effective employee and wider stakeholder representation on the allocation of available resources for investment, executive and employee remuneration, dividend payments and pension fund contributions.
- the replacement of the current 'comply or explain' culture for corporate governance codes with 'comply or else' for all aspects of corporate governance with legislation providing the framework and benchmarks for enforcement action.

The next Labour government will need to take measures to counteract the ill-effects of this misconceived, legally inaccurate and economically damaging ideology for the corporate economy.

CHAPTER 6 CORPORATE GOVERNANCE REFORMS

Previous chapter provided strong evidence to show that short-termism emanating from a shareholder centric model of corporate governance has damaged the UK economy. Fundamental reforms are needed to put the UK economy on a sound footing. This chapter discusses a number of reforms to curtail short-termism and the deeply ingrained preoccupation with share prices and short-term returns to shareholders. The 2007/08 banking crash, Carillion, BHS, Sports Direct, DPD and other headline scandals show the prevalence of ‘groupthink’ where directors are rarely challenged to explain their decisions and the consequences for stakeholders. Such a state of affairs needs to be changed so that diverse voices are present at company boards.

This chapter begins by sketching the structure of current company boards in the UK, which is shareholder-centric and does not have a place for other stakeholders. It calls for mandatory presence of stakeholders on the boards of large companies. The companies can meet the legal obligations by having stakeholder representatives on either unitary or a two-tier board structure. This chapter provides further details of the choices and issues. It calls for changes to directors’ duties, curtailment of the power of short-term shareholders and formation of a Companies Commission to enforce the proposed legal framework.

Current structure of company boards

The current structure of the company boards has become dysfunctional and despite numerous scandals has no room for the perspectives that employees, consumers and other stakeholders can bring. The board of large companies in the UK ordinarily involves executive directors led by a Chief Executive Officer. Directors are elected by shareholders only. Companies also have non-executive directors (NEDs) who are expected to provide an independent perspective. NEDs are generally part-time and typically work one-two days a month. They usually hold multiple appointments and are usually hand-picked by executive directors. The introduction of corporate governance codes which are not legally binding (but which the FCA Listing Rules require that the largest companies comply with, or else they must explain why not (so-called “comply or explain”) require the largest, listed companies to appoint a non-executive Chairman. His/Her role is to oversee the performance of the CEO, and other NEDs. The NEDs typically form committees, such as audit committee, risk committee and ethics committee, to take control over specific issues ranging from executive pay, risk assessments, internal controls, and the audit process. In practice, the part-time NEDs have little real power and little real incentive to change the way in which the company operates. Being drawn from similar backgrounds to the executive directors, NEDs have not checked soaring executive pay or predatory practices. Almost all companies involved in headline scandals, as well as banks that were bailed out during the 2007/08 crash had NEDs. Carillion’s three NEDs were paid £60,000 a year for working one-two days a month.

The directors’ duties are contained in the Companies Act 2006. Section 172 is of particular relevance because it requires directors to prioritise the interests of

shareholders above all other. The interests of employees, suppliers, local communities, customers and the environment are only to be considered in that they advance the welfare of shareholders. Section 172 is legally unenforceable as it requires shareholders to incur legal costs and take action against directors for failure to consider the interests of other stakeholders.

The 1992 voluntary code of corporate governance (Cadbury Code) was a response to numerous corporate scandals such as Barlow Clowes, Coloroll, Maxwell, Levitt Group of companies, Johnson Matthey, Bank of Credit and Commerce International (BCCI) and Polly Peck, just to mention a few. Corporate elites were not keen for the creation of a central enforcer of company law or a legally enforceable code of conduct. The government indulged them. Since then the code has been revised a number of times (most recently in July 1998) but it remains voluntary and is not legally enforceable. If anything since the 1990s, there have been even bigger scandals as demonstrated by scandals involving Alliance & Leicester, Autonomy Corporation, BAE Systems, Barings Bank, Bradford & Bingley, BT Group, Carillion, Conviviality, Co-operative Bank, Dunfermline Building Society, G4S, HBOS, MG Rover, News Corporation, Northern Rock, Rolls-Royce, Royal Bank of Scotland, Sports Direct, Standard Chartered, Tesco and many more. The voluntary codes have neither secured good governance, financial reporting and auditing, nor empowered stakeholders to call company executives to account. The “comply and explain” emphasis of the code, has hardly resulted in any useful information about tax avoidance, failure to pay the minimum wage, gender pay, executive and employee pay ratios, auditor/management conflict of interests, offshore corporate structures, profit shifting or curbed predatory mis-selling practices banks. NEDs failed to blow the whistle on any of the above practices. The corporate governance codes do not give recognition to the interests of employees, consumers or other stakeholders. The code has failed and needs to be rewritten within a statutory framework to reflect the broader needs of a society focused on long-term prosperity. The revised code will be mandatory.

Reformed company boards

Company boards need to be reformed so that they consider the long-term future of companies rather than the short-term interests of executives and shareholders. Therefore, the next Labour government must enact legislation and require all large companies to empower employees, consumers and other long-term stakeholders to ensure that their perspectives shape corporate decisions. All large companies must be required to have not just shareholder representatives, but also representatives elected by other stakeholders.

Company can choose from two board structures for corporate governance: a unitary board with elected stakeholder representation, or a two-tier board (see below).

Experience in other European jurisdictions is that direct representation of employees on both unitary and two tier-boards has helped to improve corporate performance and success for the benefit of all stakeholders⁶⁴. The presence of employee

⁶⁴ Michael Gold, Norbert Kluge and Aline Conchon, 'In the union and on the board': experiences of board-level employee representatives across Europe, Brussels: ETUI, 2010;

representatives on company boards is seen as an aid to collective bargaining, trade union recognition, employee rights, and investment and better industrial relations to ensure that companies prioritise their long-term success⁶⁵. Evidence from European companies also shows that the presence of employee representatives on company boards tends to lower CEO pay and the award of share options⁶⁶.

Many UK companies operate across Europe and already have productive and positive experience of dealing with employee directors. Their presence encourages boards to take a long-term approach to decision-making. Employees have a long-term stake in companies and their interests are affected by board decisions. Therefore, it is a matter of social justice that employee perspective should be present in discussions affecting their future. Employee and consumer representatives on company boards would bring people with a very different range of backgrounds and skills into the boardroom, which would help challenge 'groupthink'. Employee and consumer relationships are central to the long-term success of companies and the presence of these stakeholders would help boards to manage these key stakeholder relationships more effectively.

The “unitary board” model

The unitary or a single-tier board is the most common form of board in the UK and many people are familiar and comfortable with it. In this system, as the name implies, there is only one board of directors. If this option for stakeholder representation is selected then the board of large companies would contain representatives of the employees and consumers, and representatives of long-term shareholders i.e. shareholders who have held their shares for at least two years. Each director would be elected by his/her own constituency (shareholders, employees, consumers) in accordance with the rules to be specified in a new Companies Act. The representatives would serve as full directors of the board of directors with equal rights, powers and duties. The presence of stakeholder directors would mean that company decisions are informed by broader perspectives. This would mean that representatives of employees and others would be involved in remuneration and audit committees and would be in a position to raise and question executives on all major issues in the same way as other non-executive directors. As directors they would also be entitled to require the provision of all the information and facilities necessary for the performance of their functions. All directors, regardless of who elects them, would have identical duties, rights and powers and they would all work for the welfare of the company.

This is in sharp contrast to the July 2018 corporate governance code issued by the FRC, in collaboration with the government. It does not empower stakeholders or

Sigurt Vitols and Norbert Kluge, *The Sustainable Company: a new approach to corporate governance*, Brussels: ETU, 2011.

⁶⁵ Michael Gold, Norbert Kluge and Aline Conchon, 'In the Union and on the board: experiences on board-level employee representatives across Europe', Brussels: ETUI, 2010.

⁶⁶ Sigurt Vitols, *Board Level Employee Representation, Executive Remuneration and Firm Performance in Large European Companies*, March 2010; http://www.efesonline.org/Database%20of%20employee%20ownership/Users/2010_ceo_pay_paper.pdf

democratise corporations. It merely recommends that a designated director, elected by shareholders, be nominated to speak to employees and report their concerns to the board. There is a sleight of hand here as under Section 172, companies Act 2006, directors are already required to weigh the interests of employees. Still, the government policy is unacceptable because it does not empower stakeholders nor directly bring their perspective onto corporate decisions.

In other countries, reflecting their history, there are different thresholds for various forms of employee board participation. In large private companies in France, the threshold for employee representation is 1,000 employees in France (5,000 employees worldwide) and companies can choose between unitary and two-tier board structure⁶⁷. In Sweden, Denmark, Slovenia, Slovakia and Norway it varies from 25 to 50 employees. A study of the experience of employee board members in 13 European countries found that they made a genuine difference to the way in which decisions are made and to the development of a more balanced corporate strategy⁶⁸.

The unitary board route may be preferred by some because of its familiarity and may require less detailed legislation to implement. It provides a simple means by which employees/consumers can be involved in corporate decisions. Under the unitary board model all the directors of the company will be bound by the same legal duties and thus avoids any disputes over distinctive obligations. It emphasises that all the directors share the same responsibilities to the company as a whole. It fits well with the established distinction between executive and non-executive directors though their legal duties do not differ.

However, there are also drawbacks to the current unitary model. There is no easy way of differentiating between those decisions that are essentially about day-to-day management and those that affect the longer term strategy or future of the company. And on a unitary board, part-time non-executive employee/consumer directors may not be able to devote sufficient time to invigilate executive directors and question or overrule the proposals developed by full-time executives. As a minority they may also be marginalised or overruled by a combination of executive and other non-executive directors. A clearer separation of executive and supervisory roles in the two-tier board system may be more effective.

The two-tier “supervisory board” model

The two-tier board structure, sometime known as the dual board system, is less well-known in the UK. It consists of an executive board responsible for day-to-day operations, and a non-executive supervisory board (or a stakeholder board) comprising entirely of representatives elected by long-term stakeholders, such as

⁶⁷ It should be noted French companies with 50 employees or more must introduce works councils which can have up to three worker delegates, introduce profit sharing, and submit restructuring plans to the councils if the company decides to fire workers for economic reasons.

⁶⁸ M Gold, ‘Taken on Board: an evaluation of the influence of employee board-level representatives in company decision making across Europe’, 17 Journal of Industrial Relations, 2011.

employees, consumers, pension scheme members and others. The exact range of representatives would be decided by future legislation.

In the two-tier model the executive board would be responsible for the day-to-day management of the company for the benefit of its shareholders, employees, consumers and other stakeholders, with the objective of creating sustained value. It would develop business strategy and plans and ensure that all laws and internal policies are complied with.

The stakeholder board (or the supervisory board) is separate from the executive board. It would have powers and duties which are distinct from the executive directors. It would be responsible for the appointment and supervision of the executive or management board. Its main function is to focus on strategic decisions relating to investment, divestment, executive pay, dividends, mergers, takeovers and matters of long-term interest. In many European countries, stakeholder representative on the supervisory board are elected by employees, shareholders and others as they have a long-term interest in the success of the company. The key idea is to ensure that corporate decisions are informed by the stakeholder perspectives necessary for the long-term success of the company. The emphasis is on long-term success and returns to all stakeholders rather than short-term returns to shareholders. Thus, dividend considerations need to be balanced against the investment needs of the company. The Chair of the supervisory board has a significant role in overseeing the executive board of directors alongside the members of the supervisory board. The two-tier structure plays a key role in raising finance, access to capital markets, protection of pensions and resisting hostile takeovers. It can instigate processes to remove executive directors. The structure ensures that employee perspectives are brought to bear on all strategic decisions. The supervisory board would have the power to reject decisions that are not in the long-term interests of the company.

Two-tier boards are prevalent in many countries though they are most common in Germany and Austria, (see Appendix 1). Many countries permit companies to choose between a unitary and two-tier board structures and such choices are available in Denmark, France, Finland, Hungary, Luxembourg and the Netherlands. The two-tier board structure has passed the test of time. The German structures, formally adopted in 1976 and confirmed in Expert Commission reports in 2006 and 2014⁶⁹, have contributed to the maintenance of a national manufacturing base, high investment and value-added economy. In Germany, enterprises having more than 500 or 2000 employees are represented in the supervisory board, composed of one third or one half employee representatives respectively. For enterprises with more than 2000 employees, the chairman of the supervisory board, who, for all practical purposes, is a representative of the shareholders, has the casting vote in the case of split resolutions. The representatives elected by the shareholders and the representatives of the employees are equally obliged to act in the enterprise's best interests.

⁶⁹http://www.dpdhl.com/content/dam/dpdhl/Investors/Corporate_Governance/Declaration_of_Conformity/DPDHL_CG_Code_June_2014.pdf

The composition of the supervisory board is a matter for future UK legislation. In Germany, depending on the size of the company, one-third to one-half of the seats are allocated to employees. The remainder are elected by shareholders. All supervisory board members have identical rights, powers and responsibilities and must work for the long-term success of the company. Supervisory Board is chaired by a non-executive Chair, often nominated by shareholders.

In countries with two-tier boards, normally employees and shareholders have representatives on the board and both can benefit from two-tier boards. However, the system is flexible. It can empower consumers, employees, pension scheme members, local communities and others to have their voices heard and enable companies to consider decisions through a variety of perspectives.

- Just imagine what might have happened if BHS and Carillion had a supervisory board to oversee the respective executive boards. Employee representatives are likely to have objected to the failure to address the rising pension scheme deficit and may well not have approved the extraction of cash for the benefit of offshore based shareholders. Carillion borrowed heavily to pay dividends and such a strategy is unlikely to have been approved by the supervisory board. The presence of employee and other stakeholders may well have persuaded BHS and Carillion to chart an alternative course for action and survival.
- As hostile takeovers of GKN and Cadbury show, all too often long-term shareholders are marginalised by the influx of short-term shareholders aiming to make quick opportunistic gains from hostile takeovers, or demands for extra dividends. This is damaging to the long-term health of companies. All takeovers would first be screened by the supervisory board which only recommend them if they serve the long-term interests of stakeholders. The idea of restricting vote to long-term shareholders only is not new. The interim report of the Kay Review⁷⁰ considered that only long-term shareholders should have the right to vote at company meetings. It considered that only shareholders who have held shares for a minimum of two years should be entitled to vote. The rationale was that shareholders with only a short-term shareholding would be likely to vote for short-term financial gains at the expense of the long-term success of the business. In contrast, long-term shareholders have a significant attachment to the company's long-term future. This is also of benefit to the economy as companies focused on the long-term would make significant investment in assets, skills and innovation.

This paper calls for mandatory representation of employees, consumers and pension scheme members on company boards. The rationale is that their identities and qualifying characteristics can be established with certainty. However, there is no reason why the list cannot be extended to include other stakeholders. For example, in recent years there has been considerable concern about large supermarkets not paying farmers and other suppliers on time and thus jeopardising the future of the

⁷⁰ John Kay The Kay Review of UK Equity Markets and Long-Term Decision Making, London: UK Department of Business, Innovation and Skills, 2012.

supply chain. Similar concerns were also raised at Carillion⁷¹ which was taking around 126 days to pay its suppliers. The small and medium-size suppliers often do not wield sufficient economic clout to force companies to consider their plight, but government could require that supply chain stakeholders be represented on supervisory boards to ensure that their concerns are heard and shape corporate decisions.

Some of the arguments for/against stakeholder representation on unitary boards were put forward above. The same is now done for their presence on two-tier boards. The two-tier board has clarity of structure and tasks. It facilitates the separation of decisions on day-to-day management and longer term strategic issues, notably the allocation of resources between dividends and investment, and take-overs and mergers. It permits the replacement of the current system for appointing supposedly independent non-executive directors, often friendly executives from other major companies or 'cronies' of the chairman, with elected representatives of shareholders, employees and other stakeholders. It facilitates the appointment of representatives of all stakeholder interests rather than assuming an exclusive concurrence between those of management and institutional shareholders. It provides more effective control on managerial self-interest by reducing the dependence of hand-picked non-executive directors on recruitment by the chairman and executives. It permits the development of a better arms-length relationship with company auditors and can enhance their independence from company executives

The German two-tier board structure has distinctive features (see above). In other countries there are different thresholds for various forms of employee board participation. In large private companies in France, the threshold for employee representation is 1,000 employees in France (5,000 employees worldwide) and companies can choose between unitary and two-tier board structure⁷². In Sweden, Denmark, Slovenia, Slovakia and Norway it varies from 25 to 50 employees. A study of the experience of employee board members in 13 European countries found that they made a genuine difference to the way in which decisions are made and to the development of a more balanced corporate strategy⁷³.

The adoption of the two-tier board system for the largest companies within the UK is practical, as has been demonstrated by many European companies and countries. It would help to build a fairer and economically forward-looking corporate sector for all stakeholders and the community. However, the choice of whether to operate a unitary or a two-tier board structure should be left to the company and its stakeholders and legislation should provide the framework for both. Such choices are available in many countries, including France, Denmark and Finland. This could

⁷¹ House of Commons Business, Energy and Industrial Strategy and Work and Pensions Committees, Carillion, London: House of Commons, May 2018, p. 24.

⁷² It should be noted French companies with 50 employees or more must introduce works councils which can have up to three worker delegates, introduce profit sharing, and submit restructuring plans to the councils if the company decides to fire workers for economic reasons.

⁷³ M Gold, 'Taken on Board: an evaluation of the influence of employee board-level representatives in company decision making across Europe', 17 Journal of Industrial Relations, 2011.

encourage a more flexible approach in different sectors of the economy, for example by permitting the government to create new best practice participatory structures for all stakeholders in not-for-profit, utilities, railway operating companies and other publicly-owned entities while allowing experimentation in the private sector.

Key differences between the composition, duties, appointment and terms of the relative boards and powers, duties and rights on matters such as investment, dividends, pay and financial reporting are summarised in Appendix 2

The next Labour government should consult widely on what form of employee and wider stakeholder representation on company boards and what size or category of companies should be covered by these new structures in the UK. A flexible approach to the choice between two-tier and unitary boards and forms of employee and other stakeholder representation within prescribed standards and requirements may prove more acceptable than an attempt to impose uniform structures on all companies.

Selecting shareholder, employee and other stakeholder representatives

Whilst the exact proportions of board seats allocated to stakeholder representatives would be a matter for future debate and consultation, we recommend that for a company with 250 employees, at least one-third of the seats on the unitary board of a company be reserved for employee representatives, one of which could be allocated to a pension scheme trustee. One director could be elected by consumers who meets a pre-defined criteria e.g. must have been customers for two years. The identity of customers at banks, insurance, gas, water and electricity companies can easily be established. Many companies operate loyalty schemes and consumer forums for eligible customers and these too can be mobilised to identify customers eligible to stand for a seat on company boards. Other directors would be elected by long-term shareholders i.e. those holding shares for more than two years. This would enable corporate decisions to be informed by a plurality of perspectives and would loosen the groupthink that has been so dominant at company boards.

One possible minimum standard for two-tier boards in the largest companies could be an equal balance between shareholder and other stakeholder representation with an independent chair with a casting vote, as in Germany. For unitary boards, as previously indicated, the required minimum standard might be one-third employee and other stakeholder representatives, one-third non-executives representing shareholders and one third executives again with an independent chair.

The TUC report on experience in other EU countries suggests that the selection of employee representatives is relatively straightforward as they can easily be identified and organised to conduct ballots.⁷⁴ Direct election on a proportional basis for different categories of employees could be an option. In the case of banks, representation of other stakeholders in addition to that of employees can be organised from savers and borrowers as their identity is known with certainty. Provisions of this kind are well established in the cooperative and mutual sectors in

⁷⁴ Janet Williamson, 'All Aboard: Making worker representation on company boards a reality', TUC Economic Report Series, 2016.

which there is often active competition for elected board positions. Provision could also be made for the appointment of a representative of the company pension fund.

The selection of shareholder representatives may be more problematic, as they are geographically dispersed and tend to hold shares for a short period. Institutional investors have shown little enthusiasm for direct involvement in corporate governance though in recent years they have shown greater willingness to intervene in matters relating to executive remuneration. Foreign shareholders, who now hold over 50% of the shares in FTSE companies, as shown above, are even less likely to put forward candidates. In Germany many of the shareholder representatives are supplied by national or local banks. Since bank shareholding in UK companies is very low, other individuals and institutions, such as the Association of British Insurers, may need to be mobilised to recruit shareholder representatives to sit on stakeholder boards. The stakeholder board should not be a refuge for the existing pool of non-executive directors, as the stakeholder board members need to represent a diversity of interests. To secure election, the candidates will have to declare any relationship to executive directors and any potential conflict of interests.

For all new board members there should be a programme of training and development for those less experienced in strategic and financial management. This will be particularly important for employee and other stakeholder representatives on participatory boards, whether unitary or two-tier, to ensure they are composed of suitable, diverse and committed members.

In common with the current non-executive directors, stakeholder representatives will need to be reasonably well rewarded. If the current pay rates of non-executive directors are anything to go by, similar rewards should help to attract good candidates for election to stakeholder boards.

According to a PricewaterhouseCoopers (PwC) report⁷⁵, in 2017, the median base fee for non-executive directors at FTSE100 companies was about £70,000, whilst chairs received about £401,000, though these are topped-up with additional fees for chairing or participating in various committees. PwC's 2017 survey⁷⁶ of "FTSE 250 and SmallCap⁷⁷ Companies Non-Executive Director Fees⁷⁸" shows that in smaller companies fees are also substantial, as shown in the table below.

⁷⁵ PricewaterhouseCoopers, FTSE 100 Non-Executive Director fees in 2017, February 2018; <https://www.pwc.co.uk/human-resource-services/assets/EMRS/executive-management-reward-ftse-100-non-executive-director%20fee-review.pdf>

⁷⁶ PricewaterhouseCoopers, FTSE 250 and SmallCap Companies Non-Executive Director Fees in 2017, February 2018; <https://www.pwc.co.uk/human-resource-services/assets/EMRS/executive-management-ftse-250-and-smc-non-executive-director-fee-review.pdf>

⁷⁷ These are comparatively small companies ranked 351st to the 619th largest listed companies on the London Stock Exchange main market.

⁷⁸ This is available at <http://www.pwc.ie/media-centre/assets/publications/boardroom/2017/2017-pwc-ned-review-ftse250-smc-feb.pdf>

Table 3 The remuneration of non-executive chairmen, deputy chairmen, and other non-executive directors in 2016		
Role	FTSE 250 Median Fee £000s	SmallCap companies(SMC) Median Fee £000s
Chairman (Total Fee)	210	135
Deputy chairman (Total Fee)	125	79
Non-executive Director (Base Fee)	53	44
Senior Independent Director (Added Fee)	10	6
Audit Committee Chair (Added Fee)	10	8
Remuneration Committee Chair (Added Fee)	10	8
Nomination Committee Chair (Added Fee)	10	8
Risk Committee Chair (Added Fee)	14	N/A
Other Committee Chair (Added Fee)	12	N/A
Audit Committee Member (Added Fee)	5	4
Remuneration Committee Member (Added Fee)	5	4
Nomination Committee Member (Additional Fee)	5	N/A
Risk Committee Member(Additional Fee)	5	N/A
Other Committee Member(Additional Fee)	8	N/A

If, as shown, the base annual fee for a non-executive in FTSE 250 companies is £53,000 and for SmallCap companies £44,000, with additions for committee roles, it will be difficult for companies required to include employees and other stakeholders on their boards to claim that the cost will be excessive. Fees at this level should help to ensure that competent candidates put themselves forward for election or selection.

Reforming the law on the duty of directors

In the UK, wider stakeholder interests are subordinated to those of shareholders, who are legally quite separate and distinct from “the company”. Working within a dominant neoliberal mind-set, in 1998, the UK Company Law Review Steering Group rejected the view that directors must take into account wider interests than those of shareholders and instead argued that they should not be expected or required “to act as moral, political or economic arbiters”. This was given a formal statutory basis in the Companies Act 2006 which subordinated wider interests to those of shareholders as company’s only ‘members’.

Duty to promote the success of the company

(1) A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to—

- (a) the likely consequences of any decision in the long term,
- (b) the interests of the company's employees,
- (c) the need to foster the company's business relationships with suppliers, customers and others,
- (d) the impact of the company's operations on the community and the environment,
- (e) the desirability of the company maintaining a reputation for high standards of business conduct, and
- (f) the need to act fairly as between members of the company.

(2) Where or to the extent that the purposes of the company consist of or include purposes other than the benefit of its members, subsection (1) has effect as if the reference to promoting the success of the company for the benefit of its members were to achieving those purposes.

Companies Act 2006, Section 172

This formulation was accepted by the then Labour administration despite the fact that it watered down the previous legal position contained in Section 46 of the Companies Act 1980⁷⁹ (subsequently transferred to Section 309 of the Companies Act 1985) which stated that:

“(1) The matters to which the directors of a company are to have regard in the performance of their functions include the interests of the company’s employees in general, as well as the interests of its members.”

(2) Accordingly, the duty imposed by subsection (1) above on the directors of a company is owed by them to the company (and the company alone) and is enforceable in the same way as any other fiduciary duty owed to a company by its directors”

⁷⁹ There is a long history of debates behind this. In November 1977, the then Labour government published a White Paper “The Conduct of Company Directors” (Cmnd 7037). It said that “The Government ... believes that employees should be given legal recognition by company law. The statutory definition of the duty of directors will require directors to take into account the interests of employees as well as of shareholders”. The White Paper was followed by the Companies Bill 1978. In introducing the relevant clause the Secretary of State for Trade (John Smith) said: “The effect of this clause is to create a positive duty on directors: it is not merely permissive. One major consequence will be that in future directors will not be at risk, in actions brought by shareholders, simply because they have taken account of the interests of employees” (Hansard, House of Commons Debates, 20 November 1978. Though the Labour government soon got into difficulties and the Bill was lost, it was reintroduced by the incoming Conservative administration in June 1979 without any reference to employee interests. But this was re-inserted during the parliamentary proceedings of what eventually became the Companies Act 1980 (House of Lords Debates, 25 June 1979; see also House of Commons Debates, 22 October 1979.

The problem with this attempt to impose a duty to employees was that “the employees have no way whatsoever of enforcing that obligation”⁸⁰, not least as employee representatives are not present on the board. It has not as a result been tested in the courts. Many corporate lawyers and advisers have used the amended formulation of 2006 in support of the idea that it is the current share price that most accurately represents ‘shareholder value’ and that therefore during a take-over or merger the directors must advise the acceptance of the highest monetary offer, as in the take-over by Kraft of the long established Cadbury company.

A new formulation will have to ensure that there is an effective formal mechanism to require boards to take account of employee and other stakeholder’s interests. The list of interests set out in Section 172(1) is in itself satisfactory. To build an inclusive stakeholder economy where companies focus on the long-term, it will be essential to remove the reference to any overriding rights for members. The revised Section 172 could simply state that “A director of a company must act in the way s/he considers, in good faith, would be most likely to promote the success of the company for the benefit of its stakeholders as a whole”. The revised Companies Act must also give a right to any member of a reconstructed unitary board or two-tier board to take enforcement action. It may also be desirable to permit representatives of other legitimately interested bodies, such as recognised trade unions, pension trustees or consumer organisations, to take enforcement action as unlike ordinary citizens these organisations would have the resources to bring cases and safeguard stakeholder interests.

A next Labour government will need to reverse the damaging consequences of the neo-liberal mantra of maximizing shareholder value by introducing legislation to clarify any lingering doubt about the duty of directors to act in the long-term interests of the company and all its stakeholders. This could be achieved by a simple amendment of section 172 of the Companies Act, as proposed in the 2017 Manifesto, for example by replacing any reference to the ‘members’ of the company’ by a newly defined concept of ‘stakeholders’.

A Companies Commission

The UK regulatory structures are fragmented and there is no central enforcer of company law. The government has stated that the following public and private organisations have statutory responsibilities for monitoring and enforcement of company law, including corporate governance⁸¹.

⁸⁰ Hansard, House of Commons Debates, 3 March 1980.

⁸¹ Hansard, House of Lords, Written question HL8591, 13 June 2018, <https://www.parliament.uk/business/publications/written-questions-answers-statements/written-question/Lords/2018-06-13/HL8591/>; the minister also added that “This answer does not consider obligations on companies and other businesses generally such as employment regulation, environmental regulation or for reasons of public safety, or those bodies that have general responsibilities in respect of criminal investigations and prosecutions. The categorisation of bodies reflects the categorisation used for government accounting purposes and the application of the requirements of managing public money”.

Table 4
Organisations Responsible for Enforcing Company Law
Public Bodies
Bank of England (including the Prudential Regulation Authority)
Companies House
Financial Conduct Authority (FCA)
Financial Reporting Council (FRC)
Insolvency Service
Other Bodies
Association of Chartered Certified Accountants (ACCA)
Association of International Accountants (AIA)
Chartered Accountants Ireland (CAI)
Institute of Chartered Accountants in England and Wales (ICAEW)
Institute of Chartered Accountants of Scotland (ICAS)
Takeover Appeal Board
Takeover Panel

Table 4 shows the fragmentation and disarray. Each regulator works to different standards and that adds extra complications to law enforcement and promotion of good governance.

Some parts of corporate law enforcement fall to the financial sector regulators such as the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA). The parts relating to accounting and auditing are in the domain of the Financial Reporting Council (FRC), and professional accountancy bodies, such as ACCA, AIA, CAI, ICAEW and ICAS, functioning as Recognised Supervisory Bodies (RSBs) under the Companies Act 2006. The FRC checks compliance with accounting and auditing aspects of company law with particular focus on listed companies. The RSBs licence their members as auditors and check compliance with accounting and auditing aspects of the law applicable to unquoted entities. Insolvency is an inevitable feature of capitalism and is regulated by the Insolvency Service. The Accountancy bodies in their capacity as Recognised Professional Bodies (RPBs) licence about 1,600 of their members as insolvency practitioners and monitor their compliance with insolvency laws. The overlapping regulatory bodies result in duplication, waste and buck-passing and have little public accountability. Despite being statutory regulators ACCA, AIA, CAI, ICAEW and ICAS are exempt from the application of freedom of information laws. Professional bodies do not have the requisite independence from the parties that they regulate. Their regulatory role adds extra layers of complications and needs to be removed. Table 4 shows that no regulatory body is directly responsible for enforcement in the non-financial sectors.

Many areas escape monitoring and regulatory enforcement altogether. For example, some companies, including Domino's Pizza, Dunelm and stockbroker Hargreaves Lansdown⁸², have acknowledged making dividend payments in contravention of the requirements of the Companies Act, which may have implications for employees, pension scheme members, suppliers and investment by companies. In the absence of a publicly designated regulator, the Business Secretary was asked to intervene and he informed parliament that his

“Department is not responsible for carrying out checks on dividends paid by companies to ensure that they do not exceed their distributable reserves⁸³”.

Companies House is the first port-of-call for anyone seeking information about a company, its directors, officers and its financial reports. The Business Secretary told the House of Commons that

“Companies House does not have powers to verify the authenticity of company directors, secretaries and registered office addresses⁸⁴”.

The power of regulation and law lies in its capacity to adjudicate on disputes, empower and protect citizens and discipline wrongdoers. However, that capacity is eroded by the absence of independent and robust enforcement and regulators.

Companies come in many shapes and sizes and are subject to diverse forms of regulation relating to director duties, trade descriptions, shareholder rights, fraud and much more. For example, many supermarkets operate as banks and that part of their business is regulated by banking regulation and the FCA. The remainder of their business may be subject to regulation by other regulators. However, there are too many gaps and lack of any coordination amongst regulators. In its evidence to the House of Commons Treasury Committee, the FCA claimed that it lacked powers to discipline Royal Bank of Scotland (RBS) for misconduct, despite the widespread inappropriate treatment of up to 12,000 small businesses by the bank's global restructuring group (GRG) between 2008 and 2013⁸⁵. So some aspects of the business of RBS, which is a limited liability company, appear to be beyond the jurisdiction of the financial regulators. This demonstrates the need for better laws and regulatory systems. There are diverse calls for reforms of the regulatory system. For example, the Investment Association has argued that

⁸² Accountancy Daily, Two more PLCs pay out dividends breaking Companies Act rules, 16 February 2017, <https://www.accountancydaily.co/two-more-plcs-pay-out-dividends-breaking-companies-act-rules>; Financial Times, Hargreaves Lansdown breaks company law over dividend payments, 8 February 2017, <https://www.ft.com/content/44b97ab8-edda-11e6-ba01-119a44939bb6>.

⁸³ Hansard, House of Commons, 12 October 2018, <https://www.parliament.uk/business/publications/written-questions-answers-statements/written-question/Commons/2017-09-14/105198/>

⁸⁴ Hansard, House of Commons. Written Questions, 12 October 2017, <https://www.parliament.uk/business/publications/written-questions-answers-statements/written-question/Commons/2017-09-14/105222/>

⁸⁵ The Guardian, No FCA action against RBS after mistreatment of small businesses, 31 July 2018; <https://www.theguardian.com/business/2018/jul/31/fca-to-take-no-action-against-rbs-after-mistreatment-of-small-businesses>

“It is essential that Directors of companies are held accountable and appropriately sanctioned when they negligently fail to meet their duties. Recent high profile examples have clearly demonstrated that the current framework for sanctioning needs re-thinking. The current system of sanctions is fragmented between many different authorities, and often Directors are only sanctioned as a result of investigations after a company goes into insolvency. By uniting the powers and responsibilities, we would be giving real teeth to a single body who could then hold any Directors to account for being negligent of their duties⁸⁶”.

A comprehensive overhaul of the UK regulatory architecture is beyond the scope of the present paper but the number of regulators needs to be reduced and co-ordination and scope needs to be improved.

The FRC is the main regulator of corporate governance. However, it has favoured voluntary codes of governance. Such codes have not sought to democratise corporations. Indeed, their main thrust has been to prevent the development of statutory frameworks. The FRC is dominated by big corporations and accountancy firms and is funded by the same. The FRC has been described by legislators and parliamentary committees as “fatally flawed”⁸⁷, “toothless” and “useless”⁸⁸. It lacks the requisite independence to be a regulator of corporate governance and it is hard to recall any instance when despite scandals it hauled any company or executive for shortcomings in corporate governance.

There is an urgent need for a regulator to promote good governance and monitor compliance with the laws and codes. The fragmentation of the system can be reduced by eliminating the regulatory powers of the RSBs, RPBs and the FRC, and better coordination amongst regulatory bodies. In a separate paper (in progress), we argue that a newly constituted independent Companies Commission should be responsible for monitoring compliance and enforcement with all aspects of company law.

Legal enforcement, not voluntarism

This paper has called for an enforceable statutory framework to empower stakeholders. Nevertheless, there is some opposition and resistance. The resistance to any form of direct employee representation in Britain stems from a complacent and self-interested defence of established practice under which boards are

⁸⁶ The Investment Association press release, The Investment Association calls for a new body to hold directors to account, 13 June 2018, <https://www.theinvestmentassociation.org/media-centre/press-releases/2018/the-investment-association-calls-for-a-new-body-to-hold-directors-to-account.html>.

⁸⁷ IPE, Former MEP says ‘fatally flawed’ FRC should be shut down, 15 June 2018; <https://www.ipe.com/pensions/pensions/pensions-accounting/former-mep-says-fatally-flawed-frc-should-be-shut-down/10025209.article>

⁸⁸ The Times, ‘Toothless’ accountancy watchdog faces inquiry, 22 March 2018; <https://www.thetimes.co.uk/article/toothless-accountancy-watchdog-faces-inquiry-pmkxk73dv>

composed of a combination of executive and non-executive directors all of whom typically represent a prevailing managerial groupthink. The Confederation of British Industry (CBI) states that

“On employees on boards, the CBI agreed that diversity of thought throughout a business improves collective decision making, but this must be achieved in a way that maintains the structure of the unitary board system. The CBI’s response advocated an approach that requires firms to report on how they have secured employee engagement This would allow a business to make a judgement about the merits of an employee representative based on the suitability of their business practices and adopt other vehicles where more appropriate, such as an employee representative or a NED with a responsibility to engage with employees⁸⁹”.

The CBI position is unacceptable as voluntary codes have failed to secure improvement in corporate governance or performance. There is no logical reason for straitjacketing companies into a unitary board structure. Many European countries operating in the UK emanate from countries with a two-tier board system and would find it convenient to have the same structure in the UK too. Indeed, it would be appropriate to allow companies and their stakeholders to choose the board structure that best meets their concerns.

Nominating a NED to represent employees or any other stakeholder is not a substitute for directly elected employee and stakeholder representatives on company boards. Such persons directly bring stakeholder perspectives on company decision making and NEDs cannot do that. The supposedly independent non-executive directors are in practice often recruited by incumbent chairmen from their acquaintances in other commercial companies and are likely to share and reflect their values, practices and self-interest, not least as will be seen in respect of executive remuneration. They are typically co-opted in mid-term and thus presented to shareholders at AGMs in an overall slate for re-election rather than independently selected or voted on. The point of providing for direct representation of employees and other stakeholders on company boards is to ensure that their interests are genuinely and forcefully presented. The CBI opposition is a clear indication of the rejection by the current managerial class to any attempts to reform established practices⁹⁰.

The ineffectiveness of the model advocated by CBI has been repeatedly demonstrated by independent reports. The Walker Review on corporate governance in the financial sector commissioned by HM Treasury highlighted the failure of part-time non-executive directors to challenge incumbent management:

“Apart from the inadequacy of relevant financial experience in some (but not all) failed boards, it is clear that serious shortcomings of other kinds were also

⁸⁹ Confederation of British Industry, CBI calls for proportional response on corporate governance, 17 November 2016; <http://www.cbi.org.uk/news/cbi-calls-for-proportional-response-on-corporate-governance/>

⁹⁰ Department of Business, Energy and Industrial Strategy, Green paper on Corporate Governance, 2016; Government Response to Consultation 2017.

relevant, above all the failure of individuals or of NEDs as a group to challenge the executive on substantive issues as distinct from a conventional relatively box-ticking focus on process. In some cases this will have reflected the diffidence of a NED in probing complex matters where even the forming of an appropriate question is itself a challenge. But beyond and separately from this, the pressure for conformity on boards can be strong, generating corresponding difficulty for an individual board member who wishes to challenge group thinking. Such challenge on substantive policy issues can be seen as disruptive, non-collegial and even as disloyal. Yet, without it, there can be an illusion of unanimity in a board, with silence assumed to be acquiescence. The potential tensions here are likely to be greater the larger the board size, so that an individual who wishes to question or challenge is at greater risk of feeling and, indeed, of being isolate” (para. 4.3)⁹¹.

The ineffectiveness of the hand-picked non-executive in other sectors has been clearly demonstrated by the 2007-08 banking crash. All distressed banks had non-executive directors and audit committees, and none did anything to check corporate excesses which damaged shareholders, taxpayers, customers and the whole economy. BHS⁹² had a non-executive chairman, a long-time friend of its CEO Sir Philip Green, who rubber-stamped executive decisions even when he was not always invited to key board meetings. The other non-executive director was the CEO's stepson and the son of the main shareholder. Carillion had three part-time non-executive directors and an audit committee which dutifully approved all executive decisions. A similar conclusion can be drawn in respect of the performance of non-executives in respect of the only areas of decision-making that are currently reserved for them in remuneration and audit committees. There is clear evidence from an independent study of the role of non-executives in respect of executive pay that they have failed to exercise any significant restraint on levels of executive pay and that they have themselves shared in the 'ratchet effect' through which the 'going rate' for both executives and non-executives has outstripped objective measures of performance.⁹³ Nor is there any clear evidence that their work on audit committees has resulted in effective monitoring of the work of company auditors or the raising of concerns on over-optimistic or inappropriate conclusions in financial statements⁹⁴.

Unlike the voluntarist approach of the CBI, this paper recommends a statutory framework for representation of stakeholders on boards of large companies.

⁹¹ David Walker, Review of corporate governance in UK banks and other financial industry entities: Final recommendations, London: HM Treasury, 2009 (http://webarchive.nationalarchives.gov.uk/20130129110402/http://www.hm-treasury.gov.uk/d/walker_review_261109.pdf).

⁹² House of Commons Business, Energy and Industrial Strategy and Work and Pensions Committees, BHS, London: House of Commons, July 2016.

⁹³ Brian G. M. Main, Calvin Jackson, John Pymm and Vicky Wright, 'The remuneration committee and strategic Human Resource Management', in *Corporate Governance: an International Review*, Vol. 16, 2008, p. 225-238.

⁹⁴ House of Commons Business, Energy and Industrial Strategy and Work and Pensions Committees, Carillion, London: House of Commons, May 2018.

Stakeholder representatives must be directly elected by employees and consumers and be accountable for their actions.

Calls for special audits on key issues

To enhance the effectiveness of the representatives of employees and other stakeholders under either system and to break down the cosy relationship between management and auditors, new powers should be enacted for specified numbers of representatives to call for reports or a special audit on key issues.

France has arrangement under which shareholders representing more than 5% of the capital can ask the court to appoint an expert to report on a specific management operation⁹⁵.

If the general meeting has not been convened by the board of directors or supervisory board (in the case of two-tier boards) shareholders representing at least 5% of the shareholding can request the judicial appointment of a representative (*mandataire désigné en justice*) to convene a general meeting. The request has to comply with the company's corporate interest and cannot be justified solely by the interest of the shareholders.

A revised Companies Act can be modelled on the above to specify the number of shareholders and other stakeholders who can demand a special audit.

A number of issues arising out of the changes proposed in this paper are highlighted in Appendix 2.

Curtailing short-termism in the AGM

Providing a voice for employees and other stakeholders on company boards is not all that is needed to secure effective industrial democracy. One of the primary foundations of the commitment to 'shareholder value' and the problems of short-termism outlined above is the fact that under the current UK regime a simple vote of shareholders in a general meeting can determine the policy and ultimate fate of a company, whether in a take-over or merger or by the replacement of its directors. Further measures will be required to ensure that the long-term wellbeing of the enterprise is prioritised and short-termism is discouraged.

There are a number of ways in which the problems of short-termism by speculative shareholders and the risk of the sale and breakup of significant manufacturing companies in the UK can be addressed. In 2012 the Kay Review of Equity Markets and Long-term Decision Making reviewed a number of major take-overs and mergers in the UK and concluded that a short-term focus on share prices and trading in the market had not resulted in satisfactory outcomes for the companies involved.⁹⁶ It also suggested that shares acquired by speculators during take-over battles should not be permitted to determine the outcome and that only those held for at least a

⁹⁵ (*Code des Sociétés Anonymes, art. L 225-230: Ord. 2005-1126 du 8 sept 2005*).

⁹⁶ Department of Business Innovations and Skills, Final Report, July 2012, available at bis-12-917-kay-review-of-equity-markets-final-report.pdf, chapter 1.

year should be entitled to vote⁹⁷. It also considered the idea that a greater reliance on the creation of different classes of shares with different voting rights, more widely relied on in other jurisdictions in the United States and Europe, might provide better protection for major UK companies from speculators. But in respect either of 'differential voting rights or specified holding periods' it was persuaded by the Association of British Insurers that 'the introduction of such proposed legislation or regulation would involve practical difficulties' and the only action recommended was that companies should consult more regularly with their major investors.⁹⁸

Other countries have been bolder in their response to the short-termism of financial capitalism. In France, for example, in a law appropriately referred to as '*moyen de lutte contre le court-termisme des dirigeants et actionnaires*' provides for double votes for those holding shares for at least two years, previously an optional measure, to be obligatory unless subsequently removed by a two-thirds majority vote in general assembly.⁹⁹ In Germany the protection against short-term self-interest by market traders is provided by substantial share-holdings by regional and national banks with an interest in the long-term stability of large and middle-sized *mittelstand* companies located in their territory.

In the UK where an increasing proportion of shares are held by international investors with no commitment to anything other than current share prices and maximising their returns something more is needed to protect the national economy.

There are a number of potential measures that may be considered to limit the influence of speculators and arbitrageurs during take-over battles:

- a bar on voting in take-overs and other specified resolutions unless the shares have been held by an identified owner for at least two years;
- the grant of double voting rights on similar grounds, as in France

Flexibility in implementation

There are a number of options for the formal implementation of the various measures set out above:

- direct legislation imposing specific or a choice of structures for companies of specified types in respect of board structures and voting systems;
- the creation of a statutory framework of corporate governance to replace the current 'comply or explain' regime with an independent regulatory body with powers to fine companies or individual that fail to comply and/or prohibit the implementation of non-compliant measures;

⁹⁷ www.bis.gov.uk/assets/BISCore/business-law/docs/K/12-631-kay-review-of-equity-markets-interim-report.pdf, paras. 3.9-3.10.

⁹⁸ Final Report, paras. 8.32-36.

⁹⁹ Loi 2014-384 du 29 mars 2014.

- a requirement on companies to adopt new internal constitutions that meet newly prescribed standards for the election of representatives of employees and other stakeholders within a specified timeframe, again under the control of a new regulatory body;
- reliance on the powers of a newly created companies Commission to deal with companies that fail to adhere to new standards for corporate governance; and
- the introduction of new model structures for the not-for-profit, utilities and publicly-owned companies.

These are not mutually exclusive options. And there are strong arguments for providing some flexibility for companies of various types and sizes to negotiate structures with employees and trade unions that meet basic standards rather than seeking to impose uniformity in all sectors.

There will be a need for primary legislation to require or authorise companies that fall within prescribed categories to provide for the inclusion of employee and other stakeholders on either unitary or two-tier stakeholder boards. Detailed provisions will be needed to ensure that companies are not able to avoid the new structures by altering their corporate status. For this purpose, definitions in respect of the number of employees within defined groups of companies operating within the jurisdiction will probably be necessary.

The precise form in which the prescribed standards are to be met, however, could be dealt with through an enforceable code of corporate governance setting out the objectives to be achieved rather than imposing a 'one-size-fits-all' structure. For example, companies could be required to negotiate with recognised unions in their sector on the means by which employee board members would be selected and on the terms of their tenure and remuneration. Provision for the appointment of other stakeholder representatives in new not-for-profit railway or utility companies or other sectors with readily identifiable consumers could similarly be formulated in terms of an obligation to identify and negotiate with credible representatives or consumer bodies on the methods of selection. This approach would clearly need to be monitored and enforced by an independent regulator with powers to impose measures in the absence of a negotiated agreement and to sanction companies and their incumbent management for a failure to comply with the code within a prescribed period. Flexibility of this kind may assist in achieving the overall objective of encouraging cooperation between directors and executives and their employees of the kind that has proved so helpful in most European jurisdictions.

Disseminating good practice

The government too has responsibility to promote good practice. Local and central governments are the biggest spenders and that spending power should be used to promote good governance practices. It should develop a 'fit and proper person' test for award of contracts over £5 million to all domestic and foreign companies and groups of companies.

The fit and proper test, amongst other things, should require companies to explain whether they have employees and other stakeholders on their company boards. This information along with information about respect for human rights, payment of UK taxes, gender discrimination, executive pay and workers' pay ratios, time taken to pay supply chain creditors, pension scheme deficits, environmental matters and other matters should enable people and local and government departments to make judgments about whether the bidders are suitable for receiving taxpayer funded contracts.

CHAPTER 7 CONCLUSIONS

The next Labour government will need to rebuild the UK economy for the benefit of all corporate stakeholders. To provide a good standard of living for all, it will need to rebalance the economy and build a manufacturing base and meet the challenges of new technologies. Short-termism is a major obstacle to rebuilding of the economy. It is embedded within the current shareholder-centric model of corporate governance and is routinely promoted by regulators and governments.

The consequences of short-termism are all too visible. Companies are being hollowed-out through obsessive increases in dividends and short-term returns to shareholders. The resulting squeeze on investment, research and development and reskilling is damaging the long term prosperity of companies and the country. The shareholder-centric model of corporate governance is dysfunctional and must be replaced by a focus on the long-term. Company executives also need to be called to account for their policies and practices. Without reforms companies will continue to pursue narrow interests, harm innocent stakeholders and further discredit themselves.

Companies are public bodies and must serve the interests of all stakeholders. That necessarily means empowering stakeholders with a long-term interest in companies. This paper argued that employees, consumers, pension schemes members and long-term shareholders have a vital interest in the long-term success of the company and must have representation on the boards of all large companies either through a unitary board or a two-tier board. This would enable employees, consumers and others to bring different perspectives on corporate decisions. Such practices are common in most European countries and have helped to build prosperous and stable companies and economies.

The empowerment of long-term stakeholders and reduced rights for short-term shareholders will enable executives to resist hostile takeover bids and pressures to provide short-term returns. It is also a necessary step towards securing a more equitable distribution of income. The pressure to pay dividends will need to be balanced against the need for investment and growth. It would enable stakeholders to have greater say on executive pay, mergers and matters of long term importance.

This paper also called for changes to the duties of directors so that the long-term success of the company for the benefit of all stakeholders becomes the main objective. It rejected the voluntary codes of corporate governance and called for legal frameworks which give stakeholders enforceable rights. It called for the creation of a Companies Commission to monitor and enforce all aspects of good governance.

Companies accustomed to getting their own way won't necessarily welcome a new social settlement which makes them more democratic and their directors accountable to long-term stakeholders, but wiser souls know that only long-term stakeholders can guide the company to long-term success.

The proposals contained in this paper will not only democratise corporations they will also change the nature of a corporation and its relationship with society and stakeholders. Two of them are the control of hostile mergers and takeovers, and the reform of insolvency law.

Mergers and takeovers

Mergers and takeovers are a key feature of market economies, but the systems which control them are frequently dysfunctional and they frequently fail to allow companies, jobs, products, markets and returns to grow¹⁰⁰. There is also the issue of competition, too big to fail and consumer choice. The UK's manufacturing base has been eroded and too many companies are sold on the nod by short-term shareholders with little regard for the long-term.

The stakeholder approach advocated in this paper will change many aspects of mergers and takeovers fundamentally. Only long-term shareholders would be able to vote on mergers and takeovers, not short-term speculators seeking to turn a quick profit on the volatility that rumours of mergers and takeovers create. Importantly, the employees of the target company will also be able to vote on the desirability of that merger or takeover through their representatives on the respective stakeholder boards for their company, or they could be empowered to vote individually and directly. All stakeholders in large companies would have consultation rights and access to extensive information so that they can make informed judgements about the merits or demerits of a mooted takeover. *There are tools in these proposals to prevent hostile takeovers from ruining viable businesses, from losing productive jobs, and from causing long-term harm to the economy.* By empowering a broader range of stakeholders in a company to speak – in particular employees and long-term shareholders – we can change the approach to predatory mergers and takeovers.

Regulators will also be required to scrutinise mergers from the broader perspective of stakeholders and society at large. The UK's economic, innovation and employment prospects must not be diminished by harmful corporate acquisitions. In future, mergers and takeovers must pass a 'public interest' test. With access to more information and to a greater range of opinions, stakeholders and markets can make better decisions.

Insolvency

The practices of insolvency would also need to change. Corporate collapses such as Carillion, BHS, Bernard Matthews and others have shown that pension schemes, employees, suppliers (often small businesses) and taxpayers are often the biggest losers. Companies like Bernard Matthews were placed into liquidation to maximise returns to shareholders, but other stakeholders were left high and dry. Upon liquidation, most of the proceeds are passed to secured creditors (usually banks) who historically have been the first in the queue for distribution. Little is left for unsecured creditors and many innocent businesses are driven ought of business. Insolvency law must be reformed so as to protect small businesses. The order of

¹⁰⁰ <https://www.forbes.com/sites/georgebradt/2015/01/27/83-mergers-fail-leverage-a-100-day-value-acceleration-plan-for-success-instead/#2ac7fd955b86>

liquidation distribution has long been established and is unfair in that one stakeholder (secured creditor) can collect most of the liquidation proceeds whilst others get little. In a stakeholder economy there must be more equitable risk-sharing arrangements. That would mean ring-fencing a significant part of the proceeds of liquidation for the benefit of unsecured creditors. Simply put, instead of all of the assets being passed to the secured creditors, a pool of assets would be reserved to protect the unsecured creditors. It is more likely that small businesses will be unsecured creditors and that the wealthy, well-advised large businesses will be secured creditors. This always prefers the large business over the small. By ring-fencing up to say 30% of the insolvent company's cash proceeds, many SMEs and other suppliers would receive a substantial sum from liquidated companies and that can make a difference to their survival. We also need to control company directors' ability to dump liabilities as that is incompatible with a stakeholder approach.

We have only sketched out briefly the improvement to our economy which can flow from the two corporate governance reforms set above. These ideas, and others, will be developed in greater detail in future policy papers.

**APPENDIX 1
EMPLOYEE REPRESENTATION ON COMPANY BOARDS IN EUROPE**

Country	Companies Covered	Common Board Structure	Employee Representation
Austria	From 300 employees (limited companies); no employee threshold for public limited companies	Two-tier	Works council has the right to choose one third of the representatives of the supervisory board
Belgium	No statutory requirement	Unitary	Employees are not represented at board level, except in a handful of publicly-owned companies, such as the Flemish public bus service company “De Lijn”, where two union officials, one from the CSC/ACV and one from the FGTV/ABVV, represent the interests of the employees. In 2008, a Belgian representative was elected onto the supervisory board of BASF SE, a European Company based in Germany
Bulgaria	No statutory requirement	Unitary or two-tier	Few publicly-owned companies have employee representatives at board level. In public limited companies with 50 employees or more, specially elected employee representatives can participate in shareholders’ meetings on a consultative basis. In limited companies, these representatives can participate in meetings of the shareholders regardless of the number employed – but only on social issues.
Croatia	From 200 employees (limited companies); no employee threshold for public limited companies	Unitary and two-tier.	Companies must have at least one employee representative at board level. The representative is appointed and recalled by the works council. If there is no

			works council the employee representative is elected by the employees.
Cyprus	No statutory requirement	Unitary	No employee representation
Czech Republic	Statutory requirement for state-owned companies. Private sector with more than 50 employees	Unitary and two-tier (only private sector companies can have unitary board)	In state-owned companies, irrespective of size, one-third of the supervisory board are employees of the company, elected by the workforce. Private sector employee representation was abolished in 2014, but reintroduced in January 2017
Denmark	From 35 employees	Two-tier system for public limited companies and a choice between a unitary or two-tier system for private limited companies	1/3 of board with a min. of 2 members (min. 3 members on the board of the parent company of a group which falls within the scope of the regulation). Employee representatives are elected by the whole workforce.
Estonia	No statutory requirement	Two-tier	Employees not on company boards but an elaborate framework of worker, employee committees
Finland	Companies with more than 150 employees	Unitary and Two-tier	Between one and four employee representatives, based on agreement with the company. Employers decide on which

			board they will sit. Employee representation is primarily provided by the union representatives, or elected representative if there are no union representatives.
France	Obligatory for state-owned companies. Private companies with 1,000 or more employees in France (5,000 worldwide), plus state-owned companies.	Unitary or two-tier	In state-owned companies with fewer than 200 employees, up to a third of the seats on the board (with a minimum of two) are reserved for employee representatives; for more than 200 employees, employee representatives account for one third of the board. Employee representation at board level is obligatory in larger shared-based companies (Société anonyme (SA) with 5,000 or more employees worldwide or 1,000 or more in France.
Germany	From 500 employees	Two-tier	Employee representatives have a right to seats on the supervisory board of larger companies – one-third in companies with 500 to 2,000 employees, half in companies with more than 2,000.
Greece	State-owned companies only; no legislative basis for employee representation at board level in the private sector.	Unitary	Employees normally elect two members onto the boards of state-owned companies.
Hungary	From 200 employees	Unitary and two-tier	Employee representatives make up one third of the members of the supervisory board in companies with more than 200 employees; fewer rights in a single-tier system.
Ireland	State-owned companies and agencies; no statutory requirement for board level	Unitary	Employee representatives in Ireland's single-tier boards are only found in the state-owned sector, where they

	representation in the private sector.		normally account for a third of the total.
Italy	No right to employee board level representation though legislation has been mooted	Unitary and two-tier	Employees are generally not present.
Latvia	No statutory requirement	Two-tier	Public limited companies must appoint a both a management board and a supervisory board. Limited companies can choose whether to have a supervisory board. However, there is no statutory requirement for employees to be represented at board level in either type of company.
Lithuania	No statutory requirement	Unitary and two-tier	A quoted public limited company (can have both a supervisory and management board, while a limited company has a single-tier board. However, in neither case is there a requirement for employees to be represented at board level.
Luxembourg	Companies with more than 1,000 employees or with a substantial state involvement, either through ownership or state aid, must have employee representatives at board level.	Unitary and two-tier	Employees generally have a third of the seats
Malta	No statutory requirement	Unitary	Employee representation is absent
Netherlands	From 100 employees	Unitary and two-tier	One-third of the members of supervisory boards in larger companies. For unitary boards – one-third of the non-executive directors.

Norway	From 30 employees	Unitary	The right to have a single employee representative at board level starts with companies with 30 employees. In companies with more than 50 workers, one-third of board members are elected by and come from the employees; possibility of extra seats in companies with more than 200 employees.
Poland	Employee representatives at supervisory board level in state-owned and privatised enterprises, as well as even greater powers in some state-owned enterprises. However, there is no right to employee representatives on the boards of private companies.	Two-tier	Privatisation has resulted in loss of employee representation. As a prelude to privatisation, government owned enterprises have been transformed into companies but the state remains the sole or majority shareholder – under the Polish terminology, they are known as commercialised companies. In these cases employees are entitled to two-fifths of the seats on the supervisory board, if the company has more than 500 employees.
Portugal	State-owned companies and public bodies; no employee board level representation in private companies	Unitary and two-tier	Legislation permits employee representation to be agreed between employers and unions.
Romania	No statutory requirement	Unitary	Employee representatives have no right to be board members in Romania, although they can attend board meetings relating to “problems of professional, economic, social, cultural and sports interest”
Slovakia	From 50 employees	Two-tier	50% supervisory board in state-owned companies and one-third in private sector (can be increased voluntarily)
Slovenia	From 50 employees	Unitary and two-tier (only Plc can)	Employee representatives have between a third and a half of the seats on the supervisory board with a two-tier structure. In companies with a single board they have at

		choose the unitary structure)	least a third. In companies with more than 500 employees (fewer than this, if the company and works council so agree), the employees can propose a labour director to deal with human resources issues.
Spain	State-owned companies with more than 1000 employees; state-owned companies with more than 500 employees in the metal sector. No general statutory right for workers to have representation at board level	Unitary	2-3 representatives
Sweden	From 25 employees	Unitary	Employees in almost all companies with more than 25 employees have the right to elect two board members. Employee representatives make up one-third of board members in around three-quarters of companies covered by the legislation. Employee representatives can never be in the majority. Employee representatives are chosen by the local union, with which the employer has a collective agreement.
Switzerland	No statutory requirement	Unitary	No participation of employees at board level.
United Kingdom	No statutory requirement	Unitary	Experiments with employee representatives at board level in state-owned companies in the 1970s ended with the election of a Conservative government in 1979.

Appendix 2
Some Issues in the Choice Between Unitary and Two-Tier Board Structures

Board Structure	Current Shareholder-centric Regime Executives +NEDs	Unitary Executives+ Stakeholders (employees, consumers)	Two-Tier
Composition	Half and half executives and non-executives; non-executive chair	One third each executives, non-executives & stakeholders	Half and half shareholder and stakeholder representatives
Appointment	In theory elected by shareholders; in practice NEDs co-opted by chair or execs	As now for executives and NEDs. Employees and consumers elected on sectoral basis.	Both shareholder and other representatives elected on sectoral basis
Term of Office	Usually on three year re-election/replacement rotation cycle	More formal three-year terms for all	Statutory regulations and/or codes of practice for election of all board members
Duties	Currently a primary duty to shareholders + a regard for the interests of other stakeholders (Section 172, companies Act 2006)	Revised statutory duty for long term interests of the company and all stakeholders	Revised statutory duty for long term interests of the company and all stakeholders
Information	All directors are entitled to have access to all relevant information; in practice NEDs often fail to ask questions	This right should apply to employee and consumer elected directors; a right to require a special audit on issues may be needed	Directors receive information in their capacity as 'directors' and not as agents of any specific stakeholder group. Supervisory board may have right to demand special audit.
Confidentiality	This is expected but not clearly regulated except in	All directors need to be bound by the same rules.	All directors need to be bound by the same rules. The concept of

	individual contracts	The concept of confidentiality is frequently used as a 'fig leaf' and should be revisited.	confidentiality is frequently used as a 'fig leaf' and should be revisited.
Day to Day Management	Generally left to executives reporting to the board	Executives report to the board but should include matters of concern to stakeholders	Regular review of reports from the executive/management board by the supervisory board
Pay Negotiations	Usually left to a nominated executive who may report to the board; collective bargaining arrangements, if any, remain operational	European experience is that these issues are left to trade union negotiations; collective bargaining arrangements, if any, remain operational	As with single tier – interference with trade union negotiation not established; collective bargaining arrangements, if any, remain operational
Executive Pay	Currently decided by NEDs and remuneration committees	Could be decided by joint committee representing shareholders and other stakeholders.	A matter for the supervisory board; could be decided by a committee representing stakeholders.
Investment	Major investment decisions usually discussed at board level but may be subordinated to shareholder returns	Long-term wellbeing of the company is the main objective; Matters other short-term returns to shareholders need to be considered	Supervisory board approval is needed; long term wellbeing of the company is prioritised; likely to favour investment over short-term returns to shareholders.
Dividends	Currently recommended by the board; must be approved by shareholders at AGM.	Currently recommended by the board; must be approved by shareholders at AGM.	Currently recommended by the board; must be approved by shareholders at AGM.
Public Accounts and Audit	Directors have a duty to prepare true and fair financial statements; reviewed by audit	The current framework may remain in place; the presence of employees and consumers	The current framework may remain in place; the presence of employees and consumers may broaden the

	committees and Neds; externally audited	may broaden the variety of information sought	variety of information sought
Takeovers/mergers/ Major Asset Sales	Currently negotiated by board with shareholder vote; hostile takeovers may be direct to shareholders	Board to make recommendations; the changes in directors' duties would require focus on what is good to the long-term wellbeing of the company rather than just shareholder interest considerations. European practice is also to consult employees	Both tiers of the board to approve; must focus on the long-term interests of the company rather than just shareholder interest considerations. European practice is also to consult employees
Company Constitution	Changes usually initiated by the board; currently requires 75% vote of shareholders	With stakeholder representations and changes in the duty of directors, the board would need to consider the impact on stakeholders before putting matters to shareholder board.	Proposals would require approval from the supervisory board. The entire board would need to consider the impact on stakeholders before putting matters to shareholder board.

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