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## LSE Department of Management response to DBEIS Green Paper, Corporate Governance Reform, November 2017

### Unpublished letter

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# **LSE Department of Management Response to DBEIS Green Paper, Corporate Governance Reform, November 2017**

## ***Introduction***

This response to the Corporate Governance Green Paper is based on the discussions at a Workshop at the London School of Economics on February 6<sup>th</sup> and 7<sup>th</sup> 2017. This was organised to obtain a better understanding of where the evidence stands on some critical aspects of corporate governance, specifically employee representation and senior executive pay, and to discuss the policy implications. We organised the workshop into sessions on board diversity (including worker membership of boards); employee consultation; employee participation and board pay; each with a focus on company productivity. We assembled a group of scholars and practitioners who have analysed a variety of experiences; UK, US, Japan, Germany, Nordic, as well as several emerging markets. This response represents a distillation of our discussions.

## ***Setting the Scene***

The mood of voters in developed economies including the United Kingdom and the United States suggests considerable disillusion with the functioning of existing institutions, especially concerning the distribution of income, peoples' control over their lives at work and as consumers, and the supply of secure and attractive jobs. We also feel the timing of the Green Paper to be apposite in this post-Brexit vote period because:

- The considerable legislative and administrative changes required by the UK's departure from the European Union provide an opportunity to reconsider key policy areas such as Corporate Governance.
- The UK will need to develop and strengthen its own institutions, especially those concerning Corporate Governance, in this period when the backstop to domestic institutions provided in the past decades by the European Union will be removed.
- The Brexit period will likely be associated with an increase in economic uncertainty for business, and actions which indicate resolve and establish effective norms concerning corporate behaviour will be especially needed.

In this regard, we note that the German system of codetermination, representing a fundamental shift in German corporate governance, was introduced after the 1939-45 war by the occupying powers to provide a basis for corporate efficiency and legitimacy. It is also interesting to highlight that the proposal, which is now widely regarded as a

centrepiece of German economic effectiveness, was originally strongly opposed by German industry.

### ***How to frame the issues***

In general, we believe that competitive markets are an efficient way to allocate goods, services and inputs and hence that policy intervention can only be justified to ensure markets function efficiently and in situations in which government activity can be expected to improve on the outcome. Thus, one must be clear about the problems which changes to the Corporate Governance system in the UK are intended to solve.

The principal market failures in the literature that might indicate the need for policy intervention concerning corporate governance are:

- Asymmetries of information, notably between key insider stakeholders such as employees or suppliers and the management of large firms.
- A coordination or collective action problem amongst shareholders which becomes more marked as ownership is less concentrated.
- When insider stakeholders, particularly employees, have weak 'voice' in governance, dissatisfaction may lead them to 'exit', leading to inadequate formation of firm-specific skills.

The Green Paper highlights the relationship between "good" governance and productivity, and we have found strong empirical evidence to suggest the two are positively associated. This could provide a "business case" for corporate governance reform. But the evidence also suggests that there is considerable variance of company performance both within and between types of governance arrangements. This makes it hard convincingly to establish causality, as against correlation, concerning the relationship between governance and productivity.

Besides the 'business case', our approach will therefore include exploring reforms to the corporate governance systems which might begin to address the public disquiet concerning the outcomes of current company decision making; for example facilitating the rapid rise in senior executive pay; the shifting of jobs from the UK to overseas locations; the acquisition of domestic firms as part of a global strategy, and the outsourcing and deskilling of work. These decisions may or may not be in the best interest of the shareholders and company productivity. However, current governance mechanisms do not permit a rounded evaluation of such choices, from the perspective all stakeholders, some of whom may be able to bring additional valid information to bear. Moreover, some of these company decisions may not actually be in the interests

of shareholders but are still chosen because the collective action problem limits the ability of owners to put effective constraints on management. In consequence, company decisions may not always lead to the most efficient outcomes. Finally, the inability of stakeholders to transmit their knowledge about the internal situation of the firm, and their unease at the quality and broader negative impact of some corporate decision making, may contribute to the growing sense of alienation that we observe in the political as well as the economic arena.

The evidence base on these issues is large; we will restrict our attention to a few particular elements of the corporate governance system for firms, namely mechanisms to improve employee representation on boards, and ideas to address some aspects of the collective action problem. Our responses will focus on the Green Paper Questions 3, 4, 7, 8 and 9.

***How to strengthen the ways that the interests of employees can be taken into account in large UK companies (part of Green paper Questions 7, 8, 9)?***

We have reviewed the evidence from Germany, the Netherlands and Nordic economies and the UK historical experiences of worker representation on boards. There have been a few examples of Workers' Board Representation (WBR) where the impact on corporate performance has been negligible, for example the UK experience in British Steel. For the most part, however, the evidence suggests that the company performance effects of workers representatives being on boards are often positive, and that this applies whether the Boards are unitary or dual (a distinction that is perhaps overstated given contemporary moves in UK board structures). The processes for positive impact of WBR flow via the enhanced exchange of information, a reduction in antagonistic employee-employer relationships, building on mutually beneficial cooperative solutions that have emerged in response to the recession, and improved company morale reducing for example labour turnover and increasing bottom-up innovation. There is also some evidence that board diversity can lead to smaller increases in CEO and board pay.

We therefore conclude that the objectives of both economic efficiency and social welfare discussed at the start of this paper could in principle be improved by worker representation on boards. We now focus our attention on the appropriate design for such mechanisms of WBR.

- *Type of firm:* We believe that all firms of reasonable scale could gain from the improved informational flows resulting from worker participation on boards. The Nordic legislation applies to all firms with more than 25 or 35 workers. However, broadening board representation beyond shareholders

is a major development of the corporate governance system, and we believe it should first be applied only to largest companies, and those currently facing the most sophisticated governance regulatory framework. Thus we suggest that worker representation be limited to UK public limited corporations in the first instance, though perhaps with a clear statement of intent to explore the extension of the regulations in a fixed time period to all established firms above a minimum size (say 50 workers).

- *Compulsory or upon request?* The German system of board-level codetermination is compulsory for all firms above a certain size. The Nordic countries allow for the election of worker representatives when requested by a majority of workers; in practice, the proportion of firms which have chosen to appoint worker directors is often quite modest, perhaps 35%. The problem with this Nordic approach is that, like so many other aspects of corporate governance, it faces a collective action problem – without previously well-established institutional structures for company-wide worker representation, it is difficult for the threshold of 10% of workers to be reached for the request for a ballot, and it is even harder for the 50% participation target to create worker directors to be reached. This leads us to propose that a system of worker directors should be based on an intermediate structure of employee consultative committees provided by the 2004 regulations for the Information and Consultation of Employees. We believe that both should be made *compulsory* for all private and public undertakings.<sup>1</sup>
- *Number of directors:* In the light of the experience of the 1977 Bullock Committee of Inquiry, we do not believe that the proportion of worker directors should be mandated. However, we are concerned that it will be very difficult for worker directors to be effective with only a single person on each board. The Nordic countries allow workers to elect up to one third of the board, and this seems a sensible starting point; German codetermination started with 50% in the coal and steel industries, with one-third elsewhere, which was raised also to 50% subject to size in 1976.
- *Ensuring effective representation of worker opinions:* As noted above, we believe that WBR will be most effective when it is supported by intermediate mechanisms of representation. In the German, Dutch and Nordic cases, board level representation is supported by works councils or cooperation committees<sup>2</sup>, sometimes working closely with trade unions, which enable worker directors to provide a more effective employee input into board level decisions. For the UK, research by ACAS (2014) shows that consultation works best when there is genuine two-way communication between employees and management. We propose that

board level representation should build on existing mechanisms of joint consultation as provided by the 2004 Information and Consultation of Employees Regulations (ICE) and which apply to businesses with 50 or more employees. These allow for unions to play an effective role in businesses where their membership is strong. However, it is crucial that worker directors represent the employee view of the best interests of the company, paralleling the roles of traditional directors and shareholders. The intention is not to bring issues of union-management bargaining into the boardroom.

- *Election of board level representatives:* We propose that this should follow the ICE regulations and be based on a constituency comprising all employees in the business, using the same election procedures. The position of workers who work closely with the business without being its employees, such as those in the 'gig economy', does raise important questions, but as with the ICE regulations, we feel that at the present time, this is better dealt with at the level of the business. However, this should be reviewed in five years' time when the employment status of such workers has been clarified legally. For multinationals, we note that provisions already exist for joint consultation under the *Transnational Information and Consultation of Employees (Amendment) Regulations 2010*.
- *Ensuring worker board members are effective:* Workers on boards will probably need considerable training and education in order to participate effectively and to contribute profitably to Board deliberations. The intermediate body will need to identify and train a variety of potential board members prior to their election, and to provide continuing skills development for board members from the point of election. We propose that, following the German example, worker board members are not remunerated but that their earnings are passed to the ICE to support the educational and training effort or used for hiring expert advice.<sup>3</sup> Worker board members could be supported in their directorial responsibilities by certified qualifications for worker representation overseen by accredited providers such as ACAS, TUC Union Learn, or the Industrial Participation Association. They will also need to be provided with information and knowledge concerning best practices, and possibly support to adjudicate in certain types of dispute. This could be provided by extending the role of ACAS.
- *Defining the labour force:* Most UK PLC's are global companies, with significant labour forces around the world including in emerging markets. It might be seen as divisive and nationalistic to require worker board

representation only for UK workers, though this approach is the norm for example in Germany. On the other hand, one might argue that it is not for UK regulations to set requirements for overseas workers, and that it will be extremely complex to create appropriate intermediate representative bodies, which we have argued are the central plank of successful WBR, on a global scale. We propose that the legislation explicitly allows firms to choose whether representation of workers refers to their UK or their global labour forces. For multinationals, we note that provisions already exist, and could be extended, for joint consultation involving employees in overseas units under the *Transnational Information and Consultation of Employees (Amendment) Regulations 2010*.

- *Increasing gender and ethnic diversity of board membership*: while the evidence for a simple ‘business case’ appears tantalising, measures to increase diversity can have other beneficial effects on management quality. For example, one study of France showed that efforts to increase gender diversity had encouraged firms to extend and diversify the pools of talent from which they recruited.<sup>4</sup>
- All of the current Nordic, and Dutch, and German systems of worker board representation have evolved considerably since their first establishment. The proposals in this response should allow for experimentation and review over the first years of operation.

### ***How to address the high levels of Chief Executive Officer Pay (Questions 3, 4)***

We are of the view that much of the public concern about CEO pay has been more of a reflection of the general disillusion with the establishment and reaction to rising inequality than a consequence of worries about the corporate governance system. As such, it might be best to address such worries directly through the taxation system. This would also have the benefit of increasing the marginal cost of increasing managerial incomes for firms, making remuneration committees likely to think more carefully about the cost implications of raising CEO pay.

There is not much empirical evidence linking CEO pay to performance, which might suggest that the productivity cost to limiting CEO remuneration would not be great. However, the results are more complex than this; evidence shows that CEO pay is related to the size of the firm, and if CEOs increase the size of their company, they may increase the share price even if they do not increase profit margin or productivity. Moreover, there is evidence that long term incentive schemes, which reward good performance, put upward pressure on CEO pay to compensate for the increased risk that they bear under such schemes. Finally, there is evidence to suggest that CEO pay

is higher in companies with worse corporate governance, though the causality is not clear.

Thus high CEO pay – even if unpopular – may in part be a logical consequence of current reward and incentive systems and it is unclear whether it is appropriate or feasible to address public concerns at all, let alone through arbitrary rules.

These findings lead us not to support the introduction of a pay ratio. We believe that greater transparency of information might be valuable in this area but that a compulsory pay ratio was not the optimal way to achieve this. Moreover we were concerned that the informational content of a pay ratio is not clear. Related to this, we did not consider it to be feasible to establish what a desired pay ratio would be; it would differ by sector, ownership type, according to the degree of internationalisation and so forth. We also felt that requiring the publication of a pay ratio would be difficult to implement, requiring a consistent definition of lowest paid workers and given the dangers of outlier effects.

We did however believe that CEO pay is likely to be more reflective of social norms if boards are more broadly representative of the firm and the society than as currently composed. Very high CEO pay is likely to reflect problems of collective action amongst shareholders, and these are only slowly being addressed despite increased shareholder activism in some quarters. We felt this improvement would be accelerated by a requirement for increased shareholder engagement, such as by the formation of shareholder committees and investor forums to meet prior to board and remuneration committees, and also being required to make a collective decision concerning Board proposals. Similar problems exist among senior managerial employees who have a detailed understanding of the business and its stakeholders, and we noted that in Germany, for example, there is often consultation over the rules and criteria for pay of senior managers below CEO and that a member of this body, the *Sprecherausschuss*<sup>5</sup>, is commonly one of the managerial employees on the supervisory board.

Finally, can greater employee influence have a moderating effect on the pay of top management in their firms? We heard about evidence relating the relationship between presence of employee representative organisations, namely unions, in the US, Canada, Japan, and Korea. While the nature and direction of causation remains to be established, the evidence was suggestive that greater employee consultation on such questions could potentially have an effect on the design of top management reward systems.

## **Conclusion**

To summarise our responses to each question:

Q3: “Do steps need to be taken to improve the effectiveness of remuneration committees...” We believe so and propose the election of worker representatives on boards, who also serve on remuneration committees, as well as the formation of shareholder committees, required to take positions on Board proposals.

Q4 “Should a new pay ratio reporting requirement be introduced...” We do not support this proposal.

Q7: “How can the way in which the interests of employees, customers, and wider stakeholders are taken into account at board level in the UK be strengthened...” We propose the election of worker directors backed by an intermediate representational body to supervise the election process, broadly defined, and to provide appropriate training and education. Worker directors should represent up to 1/3<sup>rd</sup> of the board.

Q8: “Which type of company should be the focus for any steps...” UK plc’s in the first instance, with review after a few years.

Q9: “How should reform be taken forward...” Adoption is likely to be limited unless based on legislation.

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February 16<sup>th</sup> 2017

## References

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Endnotes:

<sup>1</sup> The Information and Consultation of Employees Regulations 2004 applies to ‘undertakings’ in Great Britain, that is a public or private undertaking carrying out an economic activity, whether or not operating for gain’ <http://www.legislation.gov.uk/uksi/2004/3426/regulation/2/made>

<sup>2</sup> As in the case of Denmark.

<sup>3</sup> They would however need to be covered by directors’ liability insurance.

<sup>4</sup> Ferreira, Daniel; Ginglinger, Edith; Laguna, Marie-Aude; and Skalli, Yasmine (2016) The Effect of Board Quotas on Female Director Turnover, unpublished working paper, London School of Economics.

<sup>5</sup> <https://www.gesetze-im-internet.de/bundesrecht/spraug/gesamt.pdf>