IPPR Commission on Economic Justice

Corporate Governance Reform

Turning business towards long-term success

Discussion paper

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IPPR Commission on Economic Justice

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IPPR Commission on Economic Justice

The IPPR Commission on Economic Justice is a landmark initiative to rethink economic policy for post-Brexit Britain.

Launched in November 2016, the Commission brings together leading figures from across society – from business and trade unions, civil society organisations and academia – to examine the challenges facing the UK economy and make practical recommendations for reform.

The Commission is undertaking a wide-ranging programme of research and policy consultation on issues including industrial strategy, macroeconomic policy, taxation, work and labour markets, wealth and ownership, sub-national economic policy and technological change. Through a major programme of communications, events and stakeholder engagement it aims to contribute to both public debate and public policy on the economy. Non-partisan, it has been welcomed by both government and opposition parties.

The Commission's Interim Report will be published in September 2017 and its Final Report in September 2018.

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NOTE

The Commission publishes discussion papers to contribute to debate on issues of major importance. These discussion papers should not be taken to represent the collective views of the Commission or the views of individual commissioners, or the organisations with which they are affiliated. They reflect only the views of their named authors. The Commission welcomes responses and reactions to them.

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Summary

Reforming corporate governance is critical to addressing the UK's longstanding economic weaknesses. 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 this.

This conclusion is based on three key propositions:

1. **The British model of corporate governance contributes to Britain's economic problems.** In giving overwhelming primacy to the rights and interests of shareholders, the way British companies are governed is a factor in our low rates of investment and productivity, high rates of pay inequality and the low level of public trust in large businesses.
    - **The primacy of shareholder interests has contributed to the growth of short-termism in British businesses**. As the average length of shareholding has fallen – from six years in the 1950s to six months now – a misalignment of incentives and behaviours has been created between companies, their shareholders and financial intermediaries.
    - **This is manifested in a decline in investment and a rise in the proportion of earnings distributed to shareholders**, **with poor long-term results both for savers and companies themselves.** Between 1990 and 2014, the proportion of discretionary cash flow returned to shareholders (including dividend payments and share buybacks) from UK non-financial corporations increased from 39 per cent to 46 per cent. Only around 25 per cent of finance raised by companies is now spent on investment.
    - **The exclusion of employee voice from corporate governance has contributed to Britain's productivity problem**. Employee engagement is a key factor in raising productivity, but has been a consistent weakness in British management culture.
    - **This model of corporate governance has contributed to a culture of rising executive pay unrelated to firm performance.** Over the last 20 years the value of the FTSE 100 has barely risen, while executive pay has increased by more than 400 per cent. Between 2010 and 2015 alone, the average pay of FTSE 100 company directors increased by 47 per cent, while average employee pay rose by just 7 per cent.

2. **Exclusive shareholder-based governance is not well founded in either theory or practice.** Most leading European economies give greater voice to key stakeholders, including employee directors on company boards.
    - **Companies are not legally 'owned' by their shareholders.** Rather, they are incorporated bodies which bring together a range of stakeholders – owners and suppliers of capital, labour, suppliers and customers – for the purpose of enterprise. There is no reason in law why shareholders alone should have control rights over the company.

- **The transformation in the character of share ownership has weakened the claim that shareholders should have exclusive oversight of the company**. A large majority of shares are now held by investment funds and overseas investors, often for very short periods of time (some for only milliseconds), with no attached intentions or responsibilities relating to the control or stewardship of the company.
- **Shareholders' control rights cannot be justified on the basis that they bear the most risk.** Shareholders can diversify their risk by having a broad portfolio of assets. Employees' risk in relation to the company is significantly greater.
- **The shareholder primacy model fails to recognise the critical role played by labour within a firm.** Employees are core constituents of the process of production, with long-term and largely exclusive contractual commitments to the company.
- **In terms of formal participation and governance rights for employees the UK comes sixth from bottom among EU countries.** Analysis of governance systems in the EU28 shows a positive correlation between governance systems which include employees, and stronger performance on productivity, business research and development (R&D) expenditure and lower inequality.

3. **Three key reforms would improve economic performance, reduce inequality and build public trust in business.** These reforms would help build purposeful companies that aim to create long-term value for the benefit of all their stakeholders, not just their shareholders.
    - **Directors' duties in company law should be reformed.** Section 172 of the Companies Act 2006 should be amended to make explicit that it is the promotion of the long-term success of a company that is the primary duty of its directors. The law should make clear that the interests of shareholders, while critical, do not necessarily take priority over the interests of employees or responsibilities to other stakeholders.
    - **Employee representation should be embedded in corporate governance, including elected worker directors on large company boards and representatives on remuneration committees.** At least two members of the board, and preferably one-third of the total, should be elected worker directors, with similar representation on remuneration committees. To ensure compliance this should be implemented through legislation, though an alternative option would be reform of the corporate governance code and its application to both listed and private companies.
    - **A Companies Commission should be established to oversee and strengthen corporate governance standards among both listed and private companies.** An independent regulator with investigative powers and legal remedies would help restore public trust in major businesses. The commission could be either an entirely new body, or build on the Financial Reporting Council, which currently oversees the governance code.

Reforming corporate governance is not a panacea on its own for Britain's economic weaknesses. But rewriting the rules that govern how firms operate is a crucial step towards building a more productive economy that works for everyone.

Introduction

Since the EU referendum vote for Brexit, it has become widely acknowledged that – as the Prime Minister has put it – the UK economy is not working for everyone. Median wages have been more or less stagnant for more than a decade, while only London and the Southeast, of all the UK's nations and regions, have recovered to their levels of output prior to the financial crisis (Jacobs et al 2016). The uncertain impacts of Brexit make economic reform both urgent and challenging.

The IPPR Commission on Economic Justice has been set up to examine the need for economic change and the possibilities for reform. As well as its Interim and Final Reports, it will publish a series of discussion papers intended to stimulate debate on key issues facing the UK economy. This paper looks at corporate governance.

Over recent months we have examined many of the submissions made to both the government's consultation and the recent BEIS Select Committee enquiry on this subject. We have received a number of submissions in response to the Commission's own call for evidence and have spoken to a range of experts and stakeholders from business, the finance sector, trade unions, academia and civil society.

Our research and deliberations have led us to three propositions, which we put forward for debate:

1. **The British model of corporate governance contributes to Britain's economic problems.** The shareholder-based model of governance is a factor in the UK's low rates of investment and productivity, our high rates of pay inequality and the low level of public trust in large businesses.
2. **Exclusive shareholder-based governance is not well founded in either theory or practice.** Most European countries give greater voice to key stakeholders, including employee directors on company boards.
3. **Three key reforms would improve economic performance, reduce inequality and build public trust in business**. Reforming directors' duties, giving greater voice to employees, and establishing a regulatory Companies Commission covering both listed and large private companies would align the UK's corporate governance model with the wider need for economic reform.

The evidence and arguments for these propositions are gathered together in the following chapters. We welcome responses.

1.
The British model of corporate governance contributes to Britain's economic problems

Beneath its headline growth figures, the UK economy exhibits two sets of serious weaknesses. On the one hand we have lower productivity than almost all of our major competitors, and productivity growth has been more or less stagnant since the financial crisis. This is caused in part by a lower – and declining – rate of investment as a proportion of GDP. With a smaller manufacturing sector than many other developed countries, and a heavy concentration of exports in a limited number of sectors, the UK's balance of trade is significantly negative. At the same time, we also have one of the most unequal of advanced economies. This is true both between households – as measured by the Gini coefficient, and by the relative shares of income growth going to the poorest half of the population and to the top 10% – and between regions of the country. Almost 40% of national GDP is concentrated in London and the southeast, and only those two regions have productivity higher than the national average. Together these characteristics have created an economy in which, despite overall growth, half of all UK households have seen little or no improvement in their incomes for more than a decade. (These problems are set out and analysed in the IPPR report *Out of Shape: Taking the Pulse of the UK Economy*, published in November 2016.)

These structural weaknesses arise from a number of different and interlocking causes, and addressing them properly in the post-Brexit era will require far-reaching reform across the economy. There is strong evidence that one of the causes relates to the way in which British companies are governed.

The British model of corporate governance gives overwhelming primacy to the rights and interests of a company's shareholders. This contrasts with governance systems common in the rest of Europe, which enshrine the rights of other stakeholders (notably employees) alongside shareholders in the governance of the firm. In the UK, only shareholders have voting rights to appoint the board of directors and to make other strategic decisions at general meetings, and the duties of directors as set out in the 2006 Companies Act are explicitly focused on their interests. Section 172 (1) of the Act makes clear that '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.' (The members of the company are its shareholders.)

In so acting, it is true that directors must 'have regard' for a series of other factors, including 'the likely consequences of any decision in the long term, the interests of the company's employees, the need to foster the company's business relationships with suppliers, customers and others [and] the impact of the company's operations on the community and the environment.'[1] But these secondary considerations, to which directors must merely 'have regard', lack clarity or strength, and it is widely acknowledged that in practice they

1 A number of other considerations to which directors must 'have regard' are also specified.

make little meaningful difference to company behaviour. The duty of directors is to the company's shareholders (BEIS Committee 2017; Collinson et al 2011).

The British model of corporate governance is simple and widely admired around the world. But it appears that it is also contributing to Britain's economic problems.

INVESTMENT AND SHORT-TERMISM

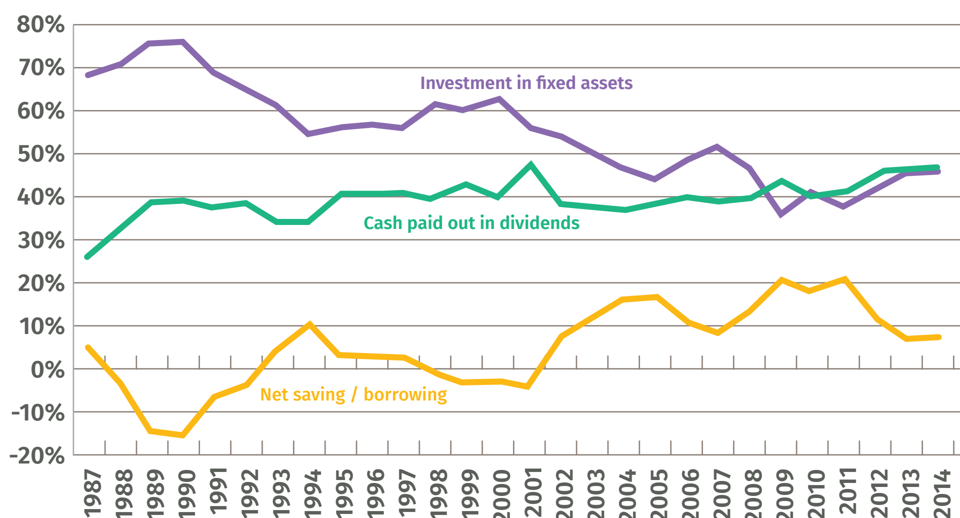
There are a number of reasons why the UK's rate of investment is lower than in other developed economies. But one of them appears to be the increasing 'short-termism' of corporate shareholders.

Over the last quarter of a century, a marked change has taken place in the behaviour of many British businesses. Companies have in aggregate been distributing more of their earnings to their shareholders, and investing less (Tomorrow's Company 2016).

As shown in figure 1, between 1990 and 2014 the proportion of discretionary cash flow returned to shareholders from UK non-financial corporations increased from 39 per cent to 46 per cent. (As a proportion of Gross Value Added it rose from 14 to 18 per cent). The inevitable result of this has been a reduction in the funds available for reinvestment, with investment declining significantly over the same period. For example, Bank of England survey data shows 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 cash (Bank of England 2017).

FIGURE 1:

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



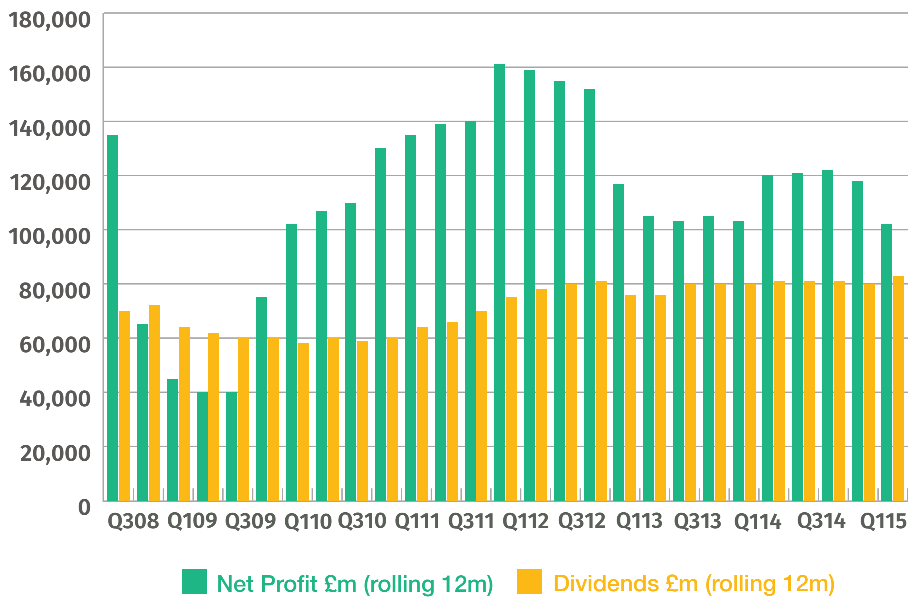
Source: Tomorrow's Company, 2016

It is notable that this trend has occurred without apparent relation to profit levels. As figure 2 shows, since the financial crisis dividend payments have remained relatively constant even as profits have fluctuated. The result is that the average 'dividend cover' (the multiple by which post-tax company earnings exceed shareholder payouts) has fallen by a quarter in the last decade, and is

now (at 1.8) at a 20-year low (Brett 2017). What appears to have been happening is that the short-term desire to guarantee and 'smooth' shareholder returns has come to dominate payout behaviour, almost irrespective of profitability.

FIGURE 2:

Dividends and profits for FTSE 350 firms, Q3 2012 to 2015

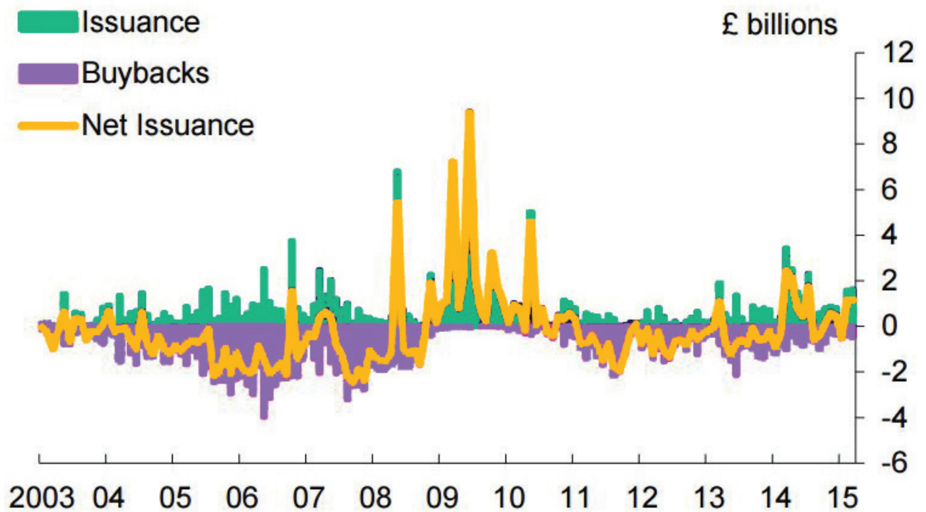


Source: Big Innovation Centre 2016

Share buybacks, another means of distributing earnings to shareholders, have also increased markedly over the last quarter of a century (Lazonick 2014). As figure 3 shows, in the last decade the value of share buybacks among UK companies has consistently exceeded the values of shares issued. This has had the surprising effect of making the equity market less a source of net new financing for UK firms than a means of extracting value from them.

FIGURE 3:

Share buybacks by UK companies on FTSE All-Share, 2003-2015

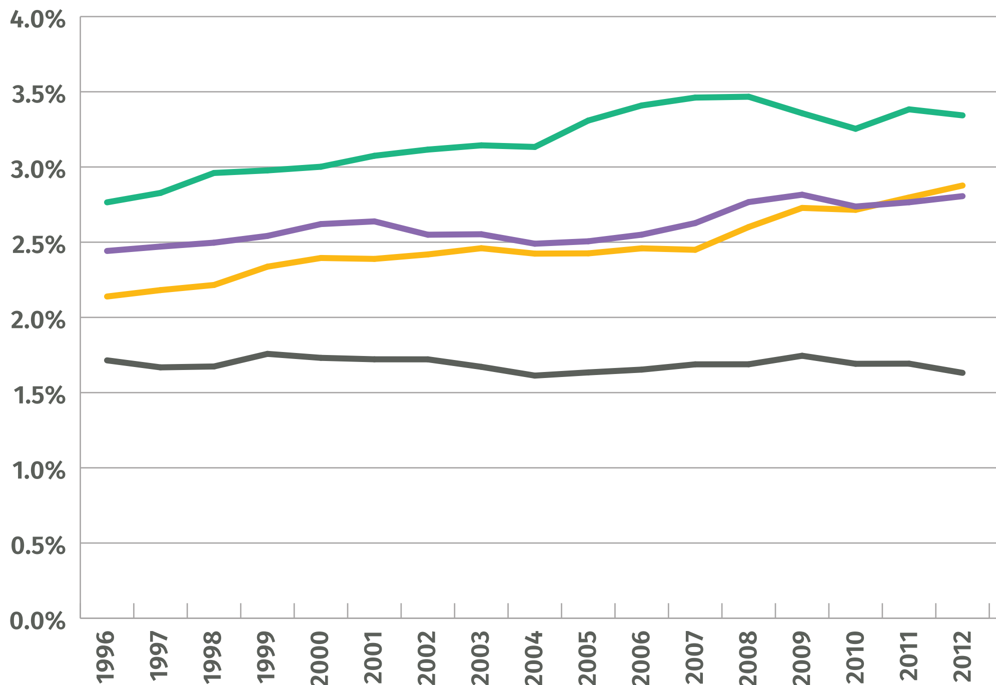


Source: Haldane 2015

As a result of these trends the UK corporate sector has gone from being a net borrower in the economy – reflecting the traditional role of companies as vehicles for channelling others' savings into investment – to being a net saver. In 2014 UK non-financial corporations ran a net surplus of £107 billion, or 7 per cent of GDP. With more earnings being distributed, the inevitable consequence has been a decline in corporate investment (see figure 1.) The UK's record on investment in research and development (R&D) has been particularly problematic: as a proportion of GDP it is not just considerably lower than most of our major competitors, but the gap with many of them (including the US, Japan and Germany) is growing (see figure 4). While the composition of the UK economy makes some of these international comparisons more complex than these figures suggest – the UK performs better than average in the OECD on intangible investment, for instance – the overall picture of relative under-investment remains clear.

FIGURE 4:

R&D spending as a percentage of GDP in the US, Japan, Germany and the UK, 1996–2012



Source: World Bank 2016

There is good reason to think that this trend towards profit distribution over investment is related in part to the UK's specific form of corporate governance. It is a pattern observed in most developed countries, but it has been most marked in the UK and US, where corporate governance is focused on shareholder interests, and where the changing patterns of share ownership and shareholder incentives have most strongly promoted short-term perspectives (Lazonick 2014).

As the Kay Review of Equity Markets and Long-term Decision Making observed in 2012, and as Bank of England Chief Economist Andy Haldane and others have analysed, increasing short-termism has resulted from a variety of factors (Kay 2012; Haldane 2016). One is the change in the nature of equity markets, which have become dominated by short-term trading rather than long-term investment. This is reflected in the length of time for which shares are on average held: this is now less than six months in the UK, down from around six years in 1950 (Haldane 2015). The structure of shareholding has also changed, with a significant decline in the proportion of quoted shares in UK domiciled companies held by individuals (down from more than 50 per cent in 1960s to around 10 per cent today) and by pension funds and insurance companies (from over half of all UK equities in 1990 to less than 15 per cent today) (ONS 2015). Both these types of shareholder are likely (though not certain) to have a greater interest in long-term growth than the various kinds of investment funds that have replaced them, whose asset managers are generally rewarded on the basis of short-term financial performance (Kay 2012). At the same time UK companies are much less likely than European companies to have 'blockholders', shareholders with significant or controlling numbers of shares, whose interests again tend to lie in long-term growth (Big Innovation Centre 2016).

If shareholders and intermediary institutions are increasingly focused on short-term returns, it seems likely that companies run in shareholders' interests will behave in more short-termist ways (such as by prioritising earnings distribution over investment) than those with different governance structures. The evidence suggests that this is the case. Studies in both the US and the UK have shown that investment is consistently and significantly higher among privately-owned companies than publicly-listed ones with otherwise very similar characteristics. This appears to be especially true in industries in which stock market prices are most sensitive to earnings (Asker et al 2011; Asker et al 2014; Davis et al 2014). As Bank of England research has shown, short-termism among financial intermediaries has a calculable cost in terms of profitable investments foregone and therefore output reduced (Davis et al 2014).

The shareholder-focused character of our corporate governance model also helps explain why takeovers in the UK are both more common and more likely to succeed than in any other advanced economy. Taking the period from 1998 to 2005 before the financial crash, the value of all mergers and acquisitions in the UK was equivalent to 21.8 per cent of GDP, compared to just 10.7 per cent in the US, 7.5 per cent in Germany, 9.9 per cent in France and a mere 2.5 per cent in Japan. At 67 per cent of bids, the UK also had the highest success rate for hostile takeovers among advanced economies in this period (Davis et al 2014). While the Takeover Code instituted after the Cadbury Report in 1992 clarified that directors are able to consider all their statutory duties when considering a bid, the fiduciary duty of shareholders to their beneficiaries is widely seen as incentivising the acceptance of takeover bids. If shareholders focused on short-term rewards favour high bid offers over the potential for long-term gain, this creates a strong pressure for directors to approve takeovers. It is now widely recognised that takeovers (particularly large ones) frequently destroy value, rather than creating it and, in the UK's case, have contributed to long-term industrial decline (Davis et al 2014).

The argument concerning short-termism is therefore essentially one about the misalignment of incentives and behaviour. The ultimate beneficiaries of company shareholdings – the millions of people collectively saving for their pensions and insurance – have an interest in long-term corporate performance. But this appears not to be true of many of the financial intermediaries – fund managers, brokers and advisers – tasked with stewarding their savings. In this way the UK's model of corporate governance appears to drive suboptimal allocations of capital and decision-making, with poor results both for savers and companies themselves.

PRODUCTIVITY AND EMPLOYEE ENGAGEMENT

The UK's low rate of investment is a significant contributor to our low productivity. But there is a second reason, which also seems to be related to the way British firms are governed.

It is now widely recognised that employee engagement in decision-making is a key contributor to productivity and innovation in modern companies, particularly as a more knowledge-based economy has placed a higher premium on human capital and skill (MacLeod and Clarke 2009). The CBI, the Federation of Small Businesses and the Chartered Institute for Personnel Development have all acknowledged this and now actively promote employee engagement among their members (CBI 2016; FSB 2016; CIPD 2015). The evidence comes both from qualitative case studies of companies that have improved engagement and from quantitative analysis of the impact of higher engagement on firm-level productivity. This suggests that firms with higher employee engagement

scores have, on average, 18 per cent higher productivity than those with low engagement scores (Seppala and Cameron 2015).

However, the UK performs particularly badly in this field, which is why employee engagement is being so strongly promoted by UK business organisations. Only a third of UK employees report that they feel engaged at work and fewer than half of UK employees are satisfied with the amount of involvement they have in workplace decision making (Rayton et al 2012; Gallie et al 2012). There are no doubt many reasons for this, but one appears to be the dominant culture in Britain of 'managerial prerogative': the view that managers have the right to make business decisions as they see fit, without the involvement of employees. In turn, this seems very likely to be related to the British model of corporate governance, which in practice – with a small number of exceptions – excludes employees from representation on company boards and affords them almost no formal rights to information or involvement in decision-making.[2] It is striking that the UK's record, not just on formal governance but on other aspects of employee involvement, including trade union membership, is amongst the lowest in Europe. In the European Participation Index, which ranks employee representation and involvement, the UK comes 23rd out of 28 European countries (ETUI 2017). It seems hard not to conclude that this low level of employee engagement both in formal and informal governance contributes to our lower productivity rate. We shall explore this further in chapter 2.

EXECUTIVE PAY AND INCOME INEQUALITY

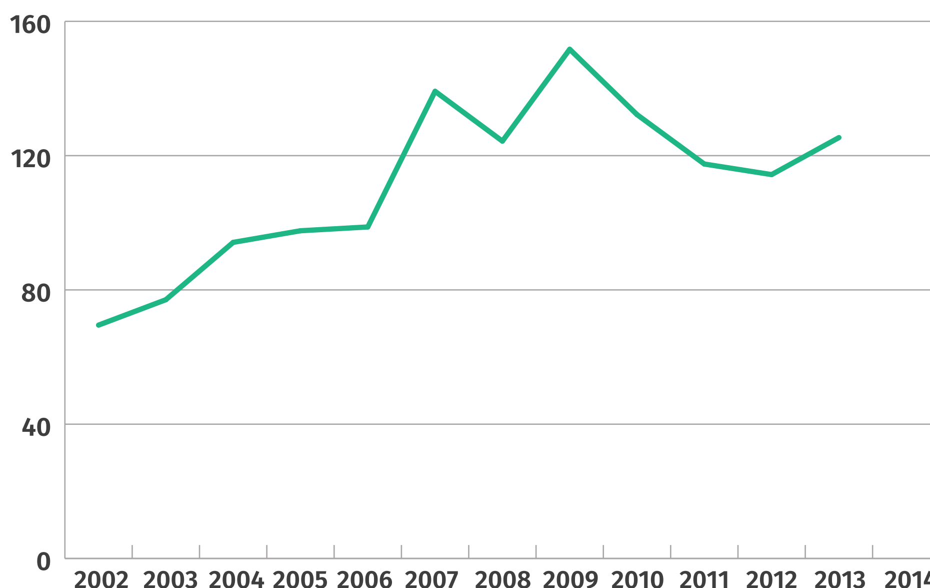
The UK remains one of Europe's most unequal societies. The incomes of the richest 10 per cent of UK households are, on average, 11 times higher than those of the poorest 10 per cent. In Germany and France, the difference is a factor of seven, and in Denmark just five (OECD 2016). A number of factors have driven increasing inequality over recent decades, including the impact of globalisation and technological change – which have increased the wage premium attached to higher skill levels – along with rising housing wealth and changes in tax rates. Another key factor is executive pay.

In the 1980s a typical top chief executive (CEO) in the UK was paid approximately 20 times as much as the average British worker (Caulkin 2015; BEIS Committee 2017). By 2002 this had risen to 70 times the average salary and by 2014 to 149 times (see figure 5). Across FTSE 100 company directors as a whole, between 2010 and 2015 average pay increased by 47 per cent, while average employee pay rose just 7 per cent (TUC 2016a).

2 There is nothing within the UK legislation or corporate governance regime that excludes the possibility of having employee representation on company boards. However, employee representatives are very rare in practice in UK board rooms.

FIGURE 5:

FTSE 100 CEO total remuneration as multiple of average employee earnings in the economy as a whole, 2002–2014



Note: Total remuneration received covers all fixed cash payments in the year, all taxable benefits, cash bonuses paid or received in the year, expected value of deferred bonuses, expected value of incentive awards awarded in the year, and the value of pension accrued or provided in the year.

Source: BEIS Committee, 2017

Rising executive pay has however not correlated with improved performance. As figure 6 shows, over the last 20 years the value of the FTSE 100 has barely risen, whereas executive pay has increased by more than 400 per cent. A study of the performance of FTSE 350 companies between 2003 and 2014 showed that, while median CEO salaries had increased by 82 per cent, the economic return on invested capital for these firms in the same period was only just over 8 per cent (CFA 2016). Individual cases of CEO pay packages bearing little relationship to company performance – including 'bonus payments' for apparently routine activity – have increasingly come to light in recent years.[3] While accelerating executive remuneration without regard to average pay or company performance is a problem in other advanced economies, the evidence suggests the challenge is particularly sharp in the UK.

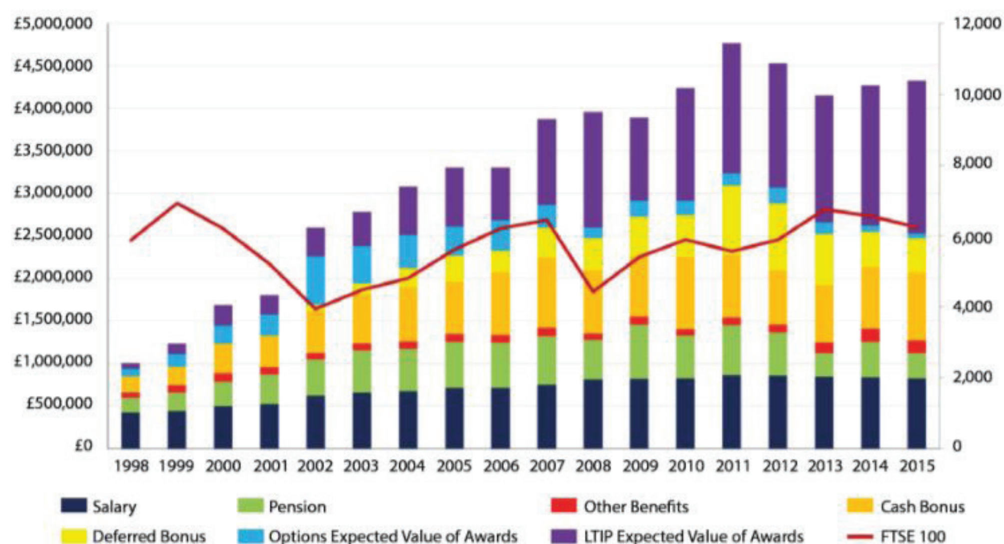
It is now widely acknowledged that corporate governance rules have done little to align directors' pay with company performance. The corporate governance code recommends that company remuneration committees should consist exclusively of independent non-executive directors, many of whom, in practice, are executive directors of other companies (TUC 2015). Along with the increasing use of remuneration consultants focused on inter-firm comparators, this has led to a self-referential system of pay awards, with very few structural incentives to hold pay to performance, and many to keep it rising. It has led, for example, to the increasing and widespread use of 'long-term incentive plans' and annual bonuses (as shown in figure 6). These have exacerbated the problem, as such plans and bonuses are based almost entirely around short-term metrics which do not

3 A prominent example was the rejection by BP's shareholders of the increased pay award to CEO Bob Dudley in 2016, following BP's record losses the previous year (Guardian 2016).

properly measure long-term performance. Indeed they are widely regarded as having distorted incentives for senior executives, encouraging them to focus on short-term share price movements rather than long-term growth (High Pay Centre 2015; Big Innovation Centre 2016). They are therefore in turn a contributor to the short-termism of corporate behaviour discussed above (FT 2016).

FIGURE 6:

Level and structure of average FTSE 100 CEO pay and FTSE 100 index (as of 31 December 2015)



Source: BEIS 2016

New regulations were introduced in 2014, requiring increased reporting on executive pay and giving shareholders an annual advisory vote on pay awards and a binding vote every three years on remuneration policy. But these do not yet appear to have had significant impact. So far, 93 per cent of votes have been in favour of recommended pay awards and policies, with only one example of a binding vote lost, along with six advisory votes (Department for Business, Energy, and Industrial Strategy 2016). While this could suggest that the proposals are working, in that the proposals put forward have been acceptable, it could also be read as indicative of a culture of inadequate scrutiny.

As the CBI and others have publicly acknowledged, the failure of the current governance system to control executive pay has been very damaging for public trust in British businesses, which has seen a considerable fall in recent years (CBI 2017; Edelman 2017; IPPR 2016). In a recent Institute of Business Ethics survey, executive pay was cited by over a quarter of respondents as their primary concern about business behaviour, behind only tax avoidance (IBE 2016). At the same time there is clear academic evidence that high wage disparities in pay between senior executives and employees is one of the sources of employee disengagement and is negatively correlated with productivity (BEIS Committee 2017).

2.
Exclusive shareholder-based governance is not well founded in either theory or practice

The British corporate governance model was codified in law in the 2006 Companies Act, but in practice it is largely based on the Corporate Governance Code. The code operates on a self-regulatory 'comply or explain' basis in which companies must disclose how they have complied with its provisions, or else explain why they have not done so. It is overseen by the Financial Reporting Council, a body originally established to set standards and provide regulatory oversight for the auditing, accountancy and actuarial professions, a role it also continues to play. The Governance Code is complemented by the Stewardship Code, a set of voluntary principles for institutional investors who hold voting rights in UK companies.

This system of corporate governance has significant strengths. Unitary boards, with a balance of executive and non-executive directors, are widely considered to provide for effective decision-making and clear channels of accountability. The Governance Code creates strong reporting requirements and effective rights for shareholders. The 'comply or explain' model combines clear principles with flexibility and has secured a high rate of compliance. 90 per cent of FTSE 350 companies report compliance with all, or almost all, of the Code's 54 provisions, while full compliance with all 54 provisions has risen from 57 per cent in 2015 to 62 per cent in 2016 (FRC 2016).

However, as we have seen, the British corporate governance model is also associated with some of the UK's key economic weaknesses, notably our low investment and productivity rates and high levels of pay inequality. These arise primarily from its core principle that companies should be run in the interests of their shareholders, and only shareholders should therefore have governance rights. In the British (and US) model, other constituencies within the company, notably employees, have almost no formal rights or representation in decision making.

THE CASE FOR SHAREHOLDER PRIMACY

The privileged position of shareholders rests on a number of well-established arguments.[4]

- First, that shareholders are the beneficial owners of companies. Companies should therefore be run in their interest, with the directors acting as their agents to maximise returns on their investment.
- Second, that the duty to promote shareholder interests helps solve the 'agency problem'[5] arising from the separation of ownership and control in a modern corporation. Obliging directors to act in the interest of shareholders, not their own interests, prevents them from excessive risk-taking and aligns risks and rights within the firm.

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4 For a fuller account see Collinson et al, 2011.

5 In corporate governance theory, an 'agency problem' is when there is a conflict of interest in any relationship where one party (the agent) is expected to act in another's best interests (the principal).

- Third, that as the 'residual claimants' on a company's earnings after others (such as employees and creditors), shareholders bear the most risk. To minimise their potential for loss, they should therefore have control rights over management.
- Fourth, that the maximisation of shareholder value is the best means to promote the efficient allocation of capital. Within neoclassical economic theory, since the price of shares reflects the profitability of companies, and welfare is maximised when resources flow to their most profitable uses, shareholder value can be taken as a proxy for the general economic interest (Manne 1965).

Each of these arguments, however, has serious flaws.

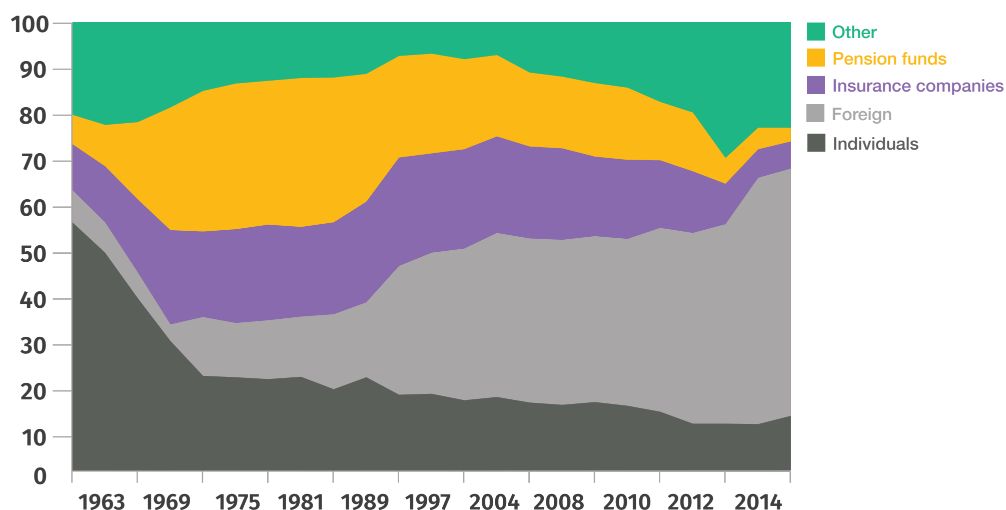
First, in law, shareholders are not the owners of the company in which they have shares. They own part of the company's capital – as constituted by their shareholdings – but this does not make them owners of the company itself. This was decisively established by the Court of Appeal in 1948, which ruled in the case *Short vs Treasury Commissioners* that 'shareholders are not, in the eyes of the law, part owners of the company'. The House of Lords strongly reaffirmed the ruling in 2003 in the case *HMRC vs Laird Group plc*, which confirmed that shareholders hold no legal or equitable interest over any property owned by the company under English company law (House of Lords 2003). It was also the basis for the European Union's 2016 Shareholder Directive (European Commission 2017). Rather than conferring ownership, shares constitute a bundle of rights and liabilities, with shareholders having the right to receive a proportionate share of the company's profit if and when dividends are declared and distributed, and the right to share in the surplus, if any, at the point of company liquidation. Whether they also carry voting rights depends on the company's constitution.

In law (and in legal theory) companies are therefore not 'owned' by their shareholders. Rather, they are incorporated bodies which bring together a range of stakeholders – owners and suppliers of capital, labour, suppliers and customers – for the purpose of enterprise. Public companies facilitate a web of contractual relationships between these stakeholders and management. This legal framework is important, since misunderstandings around ownership and the control rights derived from it help underpin the doctrine of shareholder primacy that lies at the heart of UK corporate governance. If companies are not owned by their shareholders, there is no reason in law why they alone should have control rights over the company, or for the promotion of their interests alone to govern the duties of directors.

Second, the transformation in the character of share ownership in recent decades has greatly weakened the claim that shareholders are best placed to have exclusive oversight of the company and its directors. With a large majority of shares now held by investment and hedge funds and overseas investors (see figure 7), most are held for very short periods of time – some for only milliseconds – with no attached intentions or responsibilities relating to the control or stewardship of the company. An increasing proportion – now over 10 per cent – of funds are 'passive', simply tracking the market and involving no active engagement of their 'owners' at all (Financial Times 2016). Some are traded by algorithm. Such forms of shareholding have given rise to the 'ownerless corporation', where few or no shareholders have significant holdings and few, therefore, have either the power or incentive to exercise effective control. The result is that shareholders in practice exercise very little oversight of management.

FIGURE 7:

Ownership of share capital in UK quoted companies, %, 1963-2014



Note: 'Other' includes various forms of investment fund, including index funds, exchange traded funds and hedge funds, and market participating holdings such as clearing accounts, market makers, stock lending and collateral accounts.

Source: ONS 2015

It is hard in these circumstances to claim that shareholders are best placed to decide on a company's overall direction. The average length of time a share is held, now under six months, contrasts with the average length of time an employee stays with their company, now five years and four months and this has been rising in recent years (ONS 2015). Granting all control rights over a company to its temporary shareholders, while having little regard to its considerably more committed employees, has far less justification than a generation ago.

Third, while shareholders clearly have some risk tied up in their shares, limited liability means that they are protected from personal bankruptcy if the company goes bankrupt. By contrast, employees are much more invested in the success of the firm. As Martin Wolf has pointed out, the argument that shareholders should have control rights because they have the most risk confuses diversifiable and undiversifiable risk. Shareholders can (and do) diversify their risk by having a broad portfolio of assets. They are therefore in practice likely to be rather risk-insensitive, effectively lacking the motivation to discipline risk-taking by management (Wolf 2014). Employees, on the other hand, bear risk vis-a-vis the company that is significantly harder to diversify; they therefore have a much stronger incentive to oversee management and (if they have them) to exercise control rights. Privileging the position of shareholders in corporate governance while excluding employees on the basis of who bears the most risk is therefore not justified.

Fourth, maximising shareholder value is a weak basis in economic theory or practice on which to base principles of governance. Shareholder value depends on discount rates (the way in which future returns are valued), which vary hugely for shareholders with different investment horizons. The evidence of actual corporate performance suggests that aligning managerial incentives

with the short-term interests of temporary shareholders does not increase long-term returns (Stout 2012).

Perhaps the central weakness of the shareholder primacy model is that it fails to recognise the critical role played by labour within a firm. Employees are not just another group of 'stakeholders' on a par with, say, customers or suppliers. Unlike those, they are core constituents of the process of production, with long-term and largely exclusive contractual commitments to the company. Major corporate decisions have a huge impact on the livelihoods of employees, much greater than the impact on individual shareholders. There is a strong philosophical case therefore – on grounds both of justice and participation – for employees to have at least partial governance rights over those decisions (Anderson 2017; TUC 2016b). This is reinforced by the changing nature of the contemporary capitalist company, where the decline of 'Fordist' models of hierarchical production has placed a premium on human capital in the workplace. Intangible assets 'owned' by employees – their skills, creativity and loyalty – are a key source of value for many companies today, on a par with, or even more important than, physical capital, yet currently do not generate governance rights in the same way as owning shares (Davies 2009). There are therefore both ethical and economic arguments for including workers in the way firms are governed.

EUROPEAN MODELS OF CORPORATE GOVERNANCE

While shareholder primacy is widely considered the normal form of corporate governance in the UK, US and other Anglosphere nations , it is by no means the universal model in developed countries. The most successful European economies have 'stakeholder-based' corporate governance models to varying degrees, in which shareholders are not the only parties in whose interests companies are governed. In such models, whether governed by law or social norms, companies must balance the interests of shareholders with those of employees, and in some cases others such as suppliers, lenders, customers and local communities (Allen and Carletti 2009).

Most European countries, in particular, give workers rights of decision-making in corporate governance. In 19 out of 30 European countries (the EU plus Norway and Switzerland) there is some provision for workers' representation on company boards. In 13 of these countries, including Germany, France, Hungary, the Netherlands and Scandinavia, workers have significant rights of representation across much of the private sector; in the other six, such rights are limited to certain kinds of companies, usually state-owned or privatised (ETUI 2017).

There is no single model of workers' representation on boards: this varies from country to country (TUC 2016b; Eurofound 2015). In most countries participation rights apply to both private and listed companies, but some, including France, limit them to plcs. In some countries, such as Germany and Austria, workers sit on supervisory boards in a two-tier board structure; in others, such as Sweden, Spain and Ireland, workers sit on unitary boards; while in others, such as the Netherlands, workers have the right to elect board members but these cannot be employees. Most countries restrict worker representation to companies above a certain size, from 25 employees in Sweden to 5,000 in France. In two, Austria and Croatia, it applies to all plcs. The most common provision is that worker representatives make up a third of the board, but in some countries it can be only one person and in three – including in some German firms – they may make up half the board. However even in these cases workers cannot exert a blocking or binding vote against the whole of the rest of the board. In nearly

all countries, worker directors are elected by the workforce, though in two, the Netherlands and Hungary, appointments are made at the AGM.

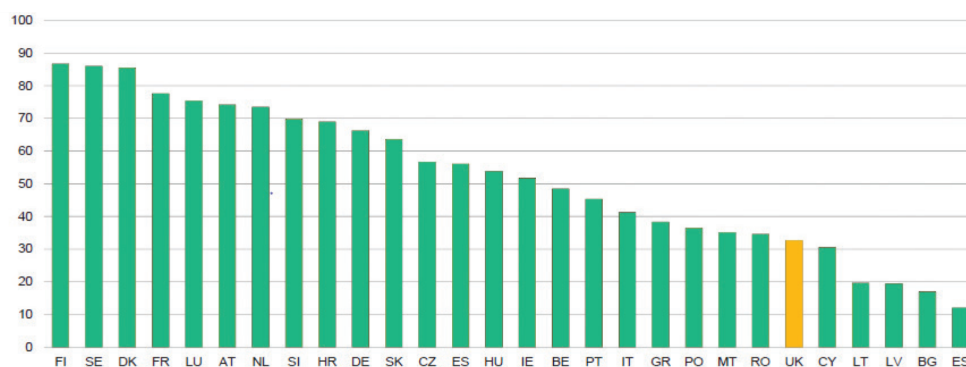
CORPORATE GOVERNANCE AND ECONOMIC PERFORMANCE

The British form of corporate governance – in which shareholders have primacy and employees have no rights of representation – is not, therefore the normal model in Europe. Indeed, most of Europe's most successful economies, including Germany, the Netherlands, Sweden and Denmark, not only give workers formal representation rights, but have wider systems of corporate governance, including works councils and other consultative structures, which give employees greater voice within firm decision making.

Overall, the UK fares very poorly in this area. The European Participation Index measures the extent of workers' rights and participation across EU countries, using four indicators: board and workplace representation, collective bargaining and trade union membership (ETUI 2017). The UK comes sixth from bottom in the EU28, ahead of only Bulgaria, Cyprus, Latvia, Lithuania, and Estonia (see figure 8).

FIGURE 8:

European Participation Index, EU28 countries, 2017



Note: the index is measured on a scale of 0-1, with higher scores representing stronger worker participation. It is a composite index including scores for rights of board representation and workplace representation, the extent of collective bargaining and proportion of workers belonging to trade unions.

Source: ETUI 2017

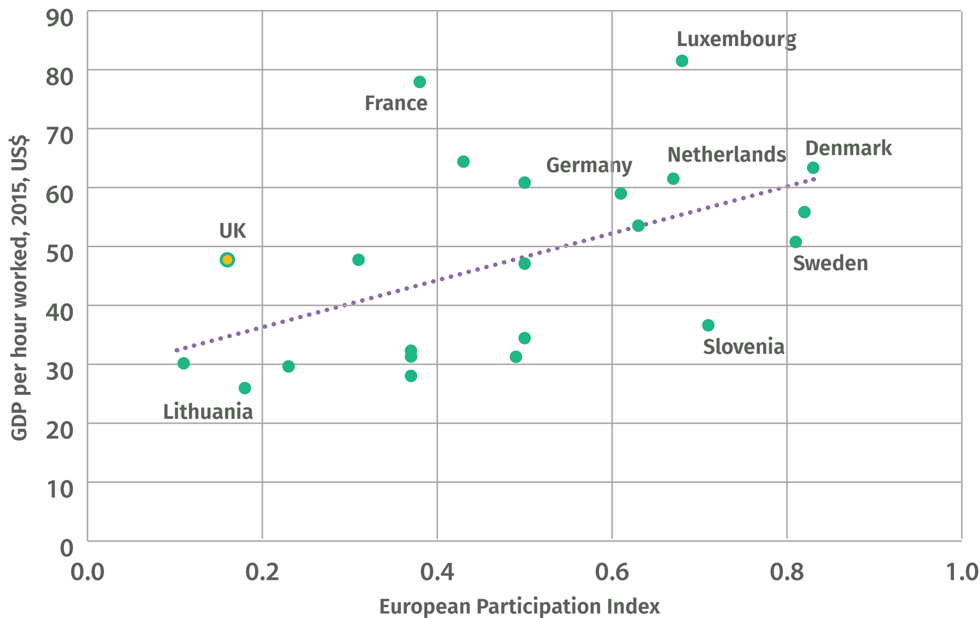
As we have seen, there are some good reasons to believe that the focus on shareholder primacy within the British model of corporate governance is a contributory factor to some of the key weaknesses in the British economy. But does giving employees a stronger voice in governance improve economic performance? It is difficult to prove this, since there are many factors which affect performance in different countries. But it is possible to identify whether there are any correlations between key dimensions of economic performance and governance models.

For the purposes of this paper, therefore, we looked at how far employee participation, as measured by the European Participation Index (EPI), correlated with performance in three dimensions of interest: private investment in research and development (chosen as a proxy for long-term investment), productivity and income inequality. The results are given in figures 9-11. They show that countries with a higher EPI score have in general higher

R&D investment, higher productivity and lower inequality. The UK, which has the second lowest EPI score, ranks poorly in all three.[6]

FIGURE 9:

The relationship between the European Participation Index and productivity, 2015



Note: EU28 excluding Bulgaria, Cyprus, Malta, Romania and Slovakia due to data availability.

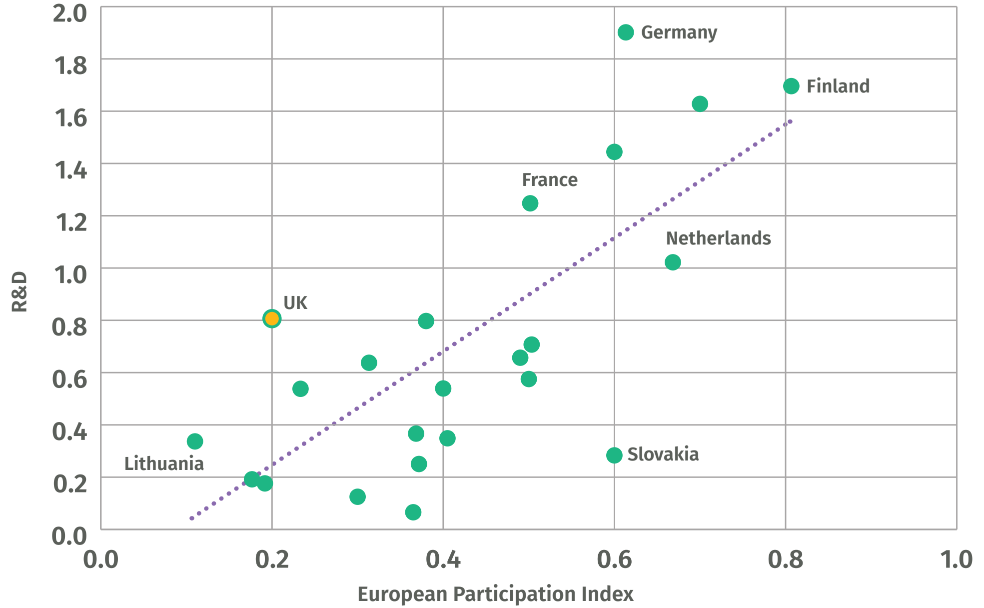
Source: IPPR analysis, using data from OECD 2017 and Vitols 2010

These charts do not show a causal link between the EPI and long-term investment, productivity or lower levels of inequality, merely a correlation. In fact, it is likely that the relationship between corporate governance and economic outcomes travels in both directions and that both indicators may be impacted by other factors. However, they clearly indicate that strong worker rights and participation do not prohibit good economic performance. As we have argued, there is good reason to think the reverse is the case.

6 IPPR also conducted this analysis specifically for the board and workplace representation indicators of the EPI, removing the collective bargaining coverage and union density indicators. The correlations remained largely unchanged.

FIGURE 10:

The relationship between the European Participation Index and business enterprise R&D expenditure as a percentage of GDP, 2014

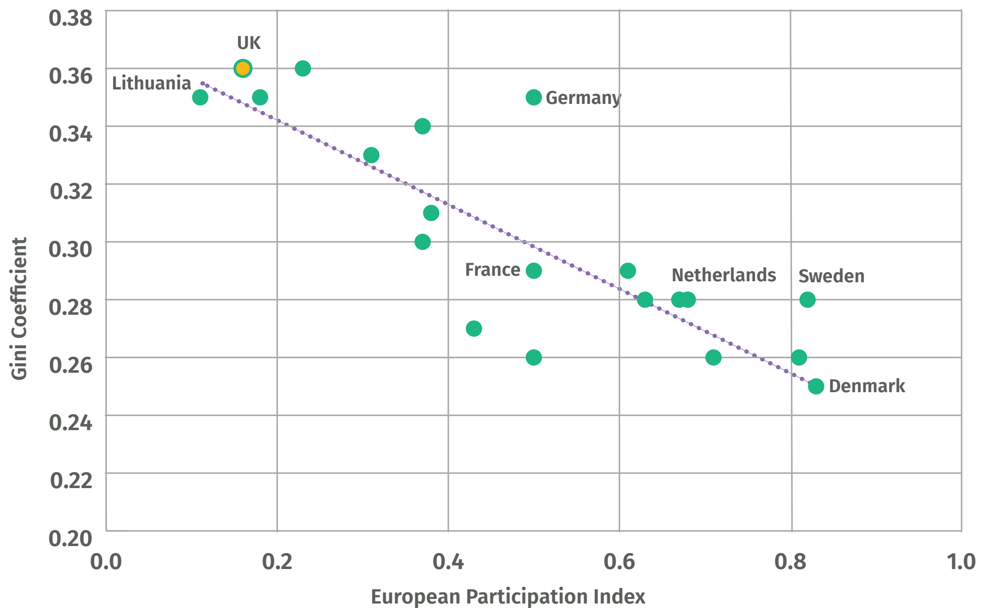


Note: EU28 excluding Belgium, Denmark, Luxembourg and Sweden due to data availability.

Source: IPPR analysis, using data from Eurostat 2017a and Eurostat 2017b and Vitols 2010

FIGURE 11:

The relationship between the European Participation Index and inequality, 2014



Note: EU28 excluding Bulgaria, Cyprus, Malta, Latvia, Lithuania, Romania and Slovakia due to data availability. The Gini coefficient is a common measure of inequality; 0 represents complete equality between income groups, 1 perfect inequality. A higher score represents a greater degree of inequality.

Source: IPPR analysis, using data from OECD 2017b and EPI

3.
Three key reforms would improve economic performance, reduce inequality and build public trust in business

If economic policy in the post-Brexit era is to reverse Britain's longstanding weaknesses in investment, productivity and inequality, we need stronger, more inclusive businesses. The British economy needs companies that invest for long-term growth; which build both physical and human capital; which innovate and take risks; and which are committed to providing good, decently-paid jobs. Over recent years a wealth of evidence has been developed on the kinds of companies that demonstrate success in these terms. They are companies with well-defined purposes, a focus on long-term value creation, strong corporate cultures, and extensive employee engagement (Tomorrow's Company 2016; Big Innovation Centre 2016; Barton et al 2017).

Britain's system of corporate governance should therefore seek to help build such companies. Corporate governance rules cannot in themselves create strong businesses. But they should create the conditions that make long-term value creation more likely and contrary behaviour less likely. It is hard to claim that our current system of corporate governance does this.

The announcement by the government in 2016 that it sought to reform corporate governance was therefore very welcome and has stimulated valuable debate. Many proposals for change have been made (BEIS Committee 2017). Most of them are minor, however, and do not adequately address the major challenges the economy faces. We therefore focus here on three key reforms that we believe would make a significant difference to the UK's long-term economic performance. In so doing, we also believe they would help restore trust in British companies, both among the general public and among their own employees. This is not to say that other, minor reforms would not also be welcome.

We believe these proposals should apply to both private and listed companies. There are now some 2,600 private firms in the UK with more than 1,000 employees, including some of the UK's most famous names, such as Allied Boots and the Virgin Group. With the advent of new sources of finance, the number of listed companies is declining (BEIS Committee 2017). While private company directors have the same duties under Section 172 of the Companies Act as those of listed firms, private companies currently have only rudimentary reporting requirements and are not subject to the corporate governance code.

This is difficult to justify. The legal separation of the company from its shareholders is the same in private companies as public ones, and private companies have the same legal protection in terms of limited liability. Major companies have significant public impact – in relation to employment, consumers, supply chains, the environment and local communities – irrespective of their ownership form. They should therefore have the same social obligations. Companies do not have to report publicly, for example, simply for the benefit of their shareholders: this is part of the public

responsibility of any large organisation to account for its behaviour. There are a number of provisions in the corporate governance code which relate to the particular structure of listed companies and therefore cannot be applied to private companies. But many of its provisions can, in some cases in a modified form.

We therefore believe that a revised version of the corporate governance code should be applied to large private companies as well as to listed ones, and that they should be subject to equivalent regulatory oversight. This should be based on a 'comply or explain' principle and be proportionate and flexible, reflecting the pluralism of private companies that such a code would cover. As the BEIS Select Committee suggested, such a code could potentially be developed collaboratively between regulators, private companies, and interested organisations (BEIS Committee 2017).

A new regime for private companies should aim to build public trust by improving transparency and confidence in them. It should serve to drive up standards of corporate governance and provide a mechanism for any potential failings to be flagged up and pursued with the company concerned.

A size threshold of 250 employees might be appropriate in the first instance for the application of the governance code to private companies. This is the established threshold for a large company in European and British company law and regulation,[7] as well as being the figure used as the threshold for other recent corporate governance requirements, such as gender pay gap reporting. However, it would be sensible to subject this to further assessment and consultation.

We also recognise that different arrangements are needed for wholly-owned UK subsidiaries of overseas companies, with greater flexibility relative to companies listed in the UK.

While noting this, each of the key reforms we set out below is aimed both at listed and large private companies.

The three reforms are as follows:

1. **Reform directors' duties** to promote the long-term success of companies and widen their intended beneficiaries beyond shareholders alone
2. **Bring employee representation into the formal governance of large firms**, including on the main board and remuneration committee
3. **Establish a Companies Commission** to provide stronger oversight and regulation of corporate governance in both listed and large private companies

Our proposals focus on the institutions of corporate governance. But promoting long-termism in British businesses will also require a shift in behaviour among shareholders. Businesses need shareholders focused on stronger stewardship of the companies in which they invest, on behalf of those whose money they are investing. While the introduction of the stewardship code in 2010 represents an important step in recognising this, much more can be done. A range of options have been proposed, including requiring shares to be held for a minimum of time before the owner acquires voting rights, removing impediments to the establishment of blockholders, creating special funds with stewardship commitments and other forms of stewardship stake,

7 Under s465 (3) of the Companies Act 2006, a large business is any company or LLP which exceeds two or more thresholds relating to turnover, balance sheet and average number of employees. These are currently a £36m annual turnover, a £18m total balance sheet, and 250 employees or more.

ensuring that the fiduciary duty on pension fund trustees is applied throughout the investment chain, and ensuring remuneration incentives and practices in investment funds promote a long-term perspective (TUC 2016b; Tomorrow's Company 2016; Big Innovation Centre 2016; BEIS Committee 2017). Each of these proposals would need significant further consideration. The Commission on Economic Justice will explore some of these options in a separate discussion paper on the financial sector. But it is clear that reviewing and strengthening investor stewardship behaviour is an important complement to corporate governance reform.

1. REFORM DIRECTORS' DUTIES

The core goal of corporate governance reform should be to help build purposeful companies that aim to create long-term value for the benefit of all their stakeholders, not just their shareholders. A number of proposals have been made for how to promote this, with valuable work undertaken by the BEIS Select Committee and the Financial Reporting Council's forthcoming review of both the UK corporate governance code and the stewardship code. For example, it has been argued that companies should have to state their core purposes in their articles of association (Big Innovation Centre 2016). Others have proposed that large companies should establish 'stakeholder advisory panels' through which boards would communicate with and be held accountable to their (non-shareholder) stakeholders (Tomorrow's Company 2017). These proposals would certainly have value. Yet, on their own, it is not clear that either would have sufficient impact to tackle the core problem. Our view is that a more fundamental reform of directors' duties is required.

Section 172 of the Companies Act, which sets out the duties of company directors, makes clear that the interests of shareholders ('members') should take primacy in determining what constitutes the 'success' of a company (see Box 1). In specifying that directors must 'have regard' to long-term consequences and to other stakeholders, Section 172 is at best unclear on how important these considerations should be, and in practice has allowed many companies to ignore them.

Box 1: Section 172 (1) of the Companies Act (current wording)

(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

There is, therefore, a strong and widely articulated case for Section 172 to be revised in such a way as to make explicit that it is the long-term success of a company to which its activities should be directed, and that the interests of

shareholders, while critical, do not take necessary priority over the interests of employees or responsibilities to other stakeholders (TUC 2014).

We would propose amending Section 172 (1) as follows:

(1) A director of a company must act in the way they consider, in good faith, would be most likely to promote the long-term success of the company, and in doing so have regard (amongst other matters) to —

(a) the interests of the company's shareholders
(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, the environment, and human rights
(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

This reformulation would make promoting the long-term success of the company its central purpose and remove the primacy of shareholders. It would give flexibility to companies in how they defined and promoted long-term success, and it would still require judgements to be made about the relative importance of the different considerations to which they must 'have regard'. But it would not automatically elevate the benefits received by shareholders over the interests of employees and over the company's responsibilities to other stakeholders. It would, therefore, represent a significant change in the fiduciary duty of directors in law and governance.

Reformulating directors' duties on these lines would help ensure that company boards did not see their responsibilities in terms of the short-term interests of shareholders, but were able instead to focus on long-term performance. To reinforce the change it would be important for companies to be required to report on this: both on how they were promoting the long-term success of the company, and how they have had regard for the other considerations specified. Such a requirement would therefore need to be introduced into the corporate governance code, expanding and clarifying the existing requirements of the annual 'strategic report'.

At present only shareholders can sue directors for breach of their duties under Section 172, since it is solely to shareholders that the current law makes directors accountable, with very few cases taken as a result. Reformulating Section 172 on the lines discussed would allow others to do this too. We propose that complaints about possible breaches of directors' duties should be able to be brought by any stakeholder to a new Companies Commission, which we set out below. The Commission should be able to investigate such allegations and, as last resort, to take directors to court for breaching their duties.

2. BRING WORKER REPRESENTATION INTO THE FORMAL GOVERNANCE OF LARGE FIRMS

Companies are institutions through which capital and labour come together to produce goods and services. It is, therefore, appropriate for a company's workers to be represented in the governance of the company, alongside the providers of capital, its shareholders. As we have argued, there is an ethical justification for this, in terms of the rights of workers to have a formal say in the strategic decisions which affect their livelihoods and for which they bear the most significant risk. There is also an economic one. Workers have a much

stronger vested interest in the long-term success of a company than most of its shareholders, and employee directors are therefore likely to be bulwarks against short-termism in corporate decision-making. Worker involvement in governance increases the engagement and loyalty of the workforce and is likely to contribute to higher productivity. The record of countries that give representation rights to employees and adopt a corresponding 'social partnership' approach to business management correlates positively with key indicators of economic performance.

Many of the arguments used to oppose employee directors reflect a lack of understanding of how such directors operate in the majority of other European countries.[8] Workers elected by the workforce become full directors of the company with the same duties to the company as a whole as other directors. This includes, for example, the same duty to respect the confidentiality of board information. Employee directors are not 'delegates' and are not there to 'negotiate' with management. Rather, their role is to bring the experience and interests of employees and workers into boardroom decision-making. They therefore help promote a diversity of perspectives and experience on the board and aid the avoidance of 'groupthink'. Surveys in Sweden and Ireland among others show that the contribution of employee directors tends to be highly valued by other board members; the level of trust between CEOs and employee directors is generally very high; and employee directors are considered to have improved industrial relations. The experience of employee directors in the UK, in companies such as the John Lewis Partnership and First Group plc, has been generally regarded as highly favourable (TUC 2016b).

We therefore propose that, as in most of Europe, large companies should have workers elected by the workforce on both their main board and on their remuneration committee. At the same time there should be wider reforms to the structure of and reporting on executive pay and to the requirements for board diversity.

Worker directors on boards

There is a strong case for introducing elected employee directors to the boards of all large listed and private companies in the UK (a threshold of 250 employees is widely considered appropriate: this would cover approximately half the UK workforce (BEIS Committee 2017)). The evidence suggests that employee directors would contribute to creating better governed, more effective companies in which all key stakeholders are represented in strategic decision-making at board level. Employee directors have been shown to enhance the quality of strategic decision-making, increase the diversity of opinion and experience on the board, and strengthen employee engagement and workplace relationships which are crucial to company success (ETUI 2017, TUC 2016b). Moreover, such a move would signal an ambition for – and help contribute towards – a different type of economy, one in which an equal partnership between labour and capital was embedded in how British companies operated. It is therefore notable that each of the major parties' manifestos in the 2017 general election included a commitment to introducing some form of employee representation at the board level, suggesting a strong political consensus in favour of reform in this area.[9]

8 This is true, for example, of some of the views expressed in the evidence provided to the BEIS Select Committee (BEIS Committee 2017).

9 For example, the Liberal Democrats committed to 'the right for employees of a listed company to be represented on the board', while the Conservative party promised to 'ensure employees' interests are represented at board level'.

A number of common sense principles, drawn from good practice in other European countries, should govern the introduction of employee directors:

- First, it is important to recognise that employee directors would be full directors, not 'delegates', with the same duties to the company as a whole as other directors (this includes the obligation to respect the confidentiality of board information). This ensures the integrity of board decision-making.
- To ensure that employee directors make a real difference to the culture and discussions of boards, and do not find themselves in the position of a 'lone voice' (which would inevitably make it harder to challenge a dominant group view), companies should have at least two employee directors. Ideally, employee directors would compose one third of the board.
- Employee directors should be elected by the entire workforce (including, if appropriate, overseas employees), with all workers eligible for nomination as a candidate subject to a minimum length of service. Having directors nominated by the board to 'represent' the views of the workforce, as is sometimes proposed as an alternative, would not generate legitimacy. Trade unions and other representative bodies should have the right to nominate candidates for such elections.
- Given the time-consuming and difficult nature of the role, employee directors should receive effective support, training, remuneration and time to perform it effectively (as other non-executive directors do).

Our proposal is to require elected employee directors on boards through legislation. We recognise that some have concerns that legally mandating changes to the composition of company boards risks being overly prescriptive and at worst could become a 'box ticking' exercise. Yet the evidence suggests it is the most effective route to introducing employee directors. Indeed, in all European countries which have workers on boards this has been enacted through statute, not through voluntary governance codes (ETUI 2017). It would also maximise the positive effect on company performance if all companies adopted employee directors on boards. If employee directors contribute to long-term improvements in decision-making it is obviously best if all companies benefit from this. For these reasons we believe that legislation is likely to have the most effect in terms of achieving change in board membership, and with it, company performance in the long run.

An alternative option would be to introduce a new provision to the corporate governance code. This would require companies (both listed and private) with more than 250 employees to introduce elected employee directors, or explain why they had not done so. The advantage of this approach would be that it would focus on the principles of the reform while giving companies flexibility in how they followed it. It would allow companies to choose the model they believed best suited their particular circumstances. However, there is a substantial risk that too many companies would simply fail to comply. This could be addressed by making clear that a review of take-up would take place after a predetermined period of time (say five years), with a commitment to legislate if sufficient progress had not been achieved.

It should be noted that as the corporate governance code does not currently apply to private companies, either the scope of the code would need to be extended to private companies or an alternative mechanism would need to be established.

It is likely that significant debate will remain regarding how best to implement change. The important point is the principle: introducing elected employee directors is the right thing to do, from both a point of view of equity and

efficiency, for both employees and companies themselves. The approach adopted should ensure it is done properly, to the greatest benefit in improving governance, and as smoothly and swiftly as possible.

Having employee directors on boards is not a panacea on its own, either for promoting long-termism in corporate decision-making or for employee voice and engagement. The latter, in particular, needs a much deeper set of institutions and practices between the strategic level of the board and the workplace. Creating a meaningfully participative culture where employees have voice and agency cannot be prescribed: all companies are different and different practices will suit particular firms best. However, at the same time, we should note that prescription plays a significant role in workforce engagement and voice in corporate governance in countries where it is generally done well. There is a lot that strengthened rights in the UK in this area could achieve. While this is beyond the scope of this paper, it is an issue the Commission will be examining in due course. However, we believe elected employee directors are an important component of corporate governance reform.

Employees on remuneration committees

Over recent years it has been widely accepted, including within the business community, that executive pay needs to be better controlled. Some measures have been taken. But there is little evidence of change. It is hard to escape the conclusion that, so long as remuneration committees are constituted as currently, comprising non-executive directors who are mainly also directors of other companies, the problem of excessive pay will remain.

We believe that requiring remuneration committees to include worker representatives is vital to bring about real change. Employees would bring a vitally different perspective to bear on the culture and deliberations of such committees. It is currently a requirement that remuneration committees must take account of the pay and conditions of staff when setting directors' pay, and the inclusion of company workers on remuneration committees would greatly assist committees in this process. Unjustified pay packages tied to short-term performance would be less likely to be accepted. It is not surprising that analysis of the largest 600 European companies shows that worker representation is correlated with lower CEO pay (TUC 2016b).

We therefore propose that the corporate governance code should be amended to require that a third of remuneration committees should be composed of elected employee representatives. At the same time, the remit of the remuneration committee should be widened to ensure that it takes account of the pay, incentives and conditions of all staff when setting directors' remuneration.

Alongside this key structural reform we would support many of the other proposals to reform executive pay now being discussed:

- Companies should be required to publish the pay ratio between company directors and the median pay of the company's workforce as a whole. While such ratios cannot simply be compared between companies, since workforce structures differ, they do provide a measure of pay inequality which allows for benchmarking within sectors and over time.
- Pay packages for executives should be simplified. The proportion of performance-related remuneration in total packages should be reduced, for example to a maximum of 10%, tied to long-term performance, and deferred for at least five years. Compensation should be linked to the key drivers of long-term value, such as innovation and productivity, not just to share prices.

- To provide for greater oversight, shareholders should be given an annual binding vote on pay policies and executive packages. If a remuneration report is opposed by 25% of shareholders, then any changes in remuneration within a year should automatically be escalated and referred back to a binding shareholder vote; and if over 50% vote against it, remuneration policy should be brought back to a binding shareholder vote within six months.

Improving diversity

Achieving greater diversity on the boards and in the senior management of major companies is a matter of both justice and effectiveness. It is now widely accepted that diversity generates a wider range of perspectives and views and greater challenge to dominant cultures and thinking (Barton et al 2017). Yet the record of British companies in this field remains very poor. Women held only 26 per cent of FTSE 100 directorships in 2016 and 20.4 per cent in the FTSE 250 (Sealy, Doldor, Vinnicombe 2016). Of 1,087 director positions in the FTSE 100, only 8 per cent were held by members of ethnic minorities, despite the fact that 14 per cent of the total UK population is from a non-white ethnic group (Parker Review 2016).

We would therefore support the proposal that companies with more than 250 employees (both listed and private) should be required under the corporate governance code to establish a diversity policy with measurable objectives for achieving gender and ethnic diversity among both board members and senior management. In particular, companies should be required to set out clearly how they are going to achieve gender-balanced boards by 2020. Nomination and appointment processes for boards should be transparent, with all positions publicly available.

3. ESTABLISH A COMPANIES COMMISSION

Corporate governance is currently weakly regulated and enforced. The Financial Reporting Council (FRC) only has powers to monitor a company's strategic report and financial statements and (in a hangover from its institutional origins) can only take action against directors in breach of the corporate governance code if they happen to be accountants, auditors or actuaries. It is currently further constrained by limited resources[10] and the limited extent of its powers. At the same time, shareholders are the only constituency within the company that can bring a suit against the directors if they are in breach of their duties under Section 172 of the Companies Act. The governance of private companies is not effectively regulated at all. Routes of redress are therefore narrow in terms of who is able to take action and weak in what can be done to enforce good governance. This undermines both the effectiveness of corporate governance itself and public trust in the system – particularly in the light of well-publicised cases such as those of BHS and Sports Direct.

It is notable that the FRC's powers are much weaker than those of other UK corporate regulators. For example, the Care Quality Commission has extensive investigatory powers, of which it makes frequent and proactive use in response to complaints. When breaches of practice are found it can impose conditions, and suspend or cancel the registration of care providers. Failure to comply with its enforcement orders is a criminal offence. Many other countries have comparably powerful and well-resourced regulators overseeing corporate governance, with effective powers of enforcement. The Australian Securities

10 The FRC currently receives funding from companies, insurance companies, some pension funds, the actuarial and accountancy professions and until recently from government.

and Investment Commission provides a notable example, having the power to investigate and take action against directors for breach of their legal duties.

We therefore propose the creation of a new statutory Companies Commission to oversee and enforce both a reformed corporate governance code and Section 172 of the Companies Act. Such a Commission would take over the corporate governance functions of the current FRC, acting as an independent regulator with investigative and enforcement powers. The Commission would cover both publicly listed and private companies.

One option in terms of creating a Companies Commission would be to strengthen and reconstitute the Financial Reporting Council. The FRC has recently indicated a willingness to take on extra responsibilities and this direction of reform was also suggested by the recent BEIS Select Committee report (BEIS Committee 2017). There would clearly be merits either in the evolution of the FRC or in establishing a new institution with a new mission. In either case its powers and resourcing would need to be well defined and sufficient for the task.

We believe such a Commission should:

- monitor and publish information on the state of corporate governance based on companies' strategic reports
- have the power to investigate possible breaches of corporate governance, both under the corporate governance code and Section 172 of the Companies Act, in response to complaints
- propose remedies to a company's board of directors where it believed the company was in breach of the governance code or Section 172
- in cases of serious alleged breaches of directors' duties under Section 172, have the power if necessary to take the company to court as a public interest litigator

Where the Commission believed that a company was in breach of either Section 172 or the corporate governance code, it would seek initially to engage privately with the company's board of directors, and to ask that its proposed remedies were implemented. If it was not satisfied that this had been done, it would have the power to publish its findings. We believe that these sanctions should be sufficient to provide a strong incentive for companies to comply. Only as a last resort would litigation under Section 172 be used against the company as such. An intermediary disciplinary step to induce change could be the power to withdraw the privilege of being a director from those failing to uphold their duties.

To ensure public trust, it would be important for the Companies Commission to have broad representation. Its members should come from all key corporate stakeholders, including shareholders, employees (including trade unions), consumers and civil society.

Conclusion

The best British businesses are world class. They do what society needs them to do: create long-term wealth; provide good work and sustainable livelihoods for large numbers of people; build both physical and human capital; and generate innovation. But too many British businesses are not doing this. The aggregate record of business investment, productivity and inequality over the last quarter of a century has left the UK economy seriously underperforming its major competitors. There are good reasons, as we have seen, to believe that the British model of corporate governance is part of the reason. Corporate governance reform alone will not solve these problems. But we believe that our proposals will produce more purposeful, long-term-orientated companies, with stronger employee engagement and greater public accountability. They would therefore contribute to the wider economic reform that Britain needs.

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