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House of Commons BIS Select Committee

Inquiry on corporate governance

Response from the Employment Lawyers Association

26 October 2016

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INTRODUCTION

The Employment Lawyers Association ("ELA") is a non-political group of specialists in the field of employment law and includes those who represent Claimants and Respondents/Defendants in the Courts and Employment Tribunals. It is therefore not ELA's role to comment on the political merits or otherwise of proposed legislation, rather to make observations from a legal standpoint. ELA's Legislative and Policy Committee ("the L&P Committee") and the working party set up to respond to this particular consultation are made up of both Barristers and Solicitors, working in private practice and in-house, who act for both Claimants and Respondents. The L&P Committee meets regularly for a number of purposes including to consider and respond to proposed new legislation.

The working party was chaired by Jonathan Chamberlain of Gowling WLG LLP. The working party members are listed at the end of this document.

1 SUMMARY

1.1 As a politically-neutral organisation made up of lawyers who represent both employers and employees, ELA has no view on the best model of corporate governance.as such. In making this submission, ELA's concern is to make sure that whichever model is preferred, that both it and any subsequent regulation are effective to deliver the chosen policy aim.

1.2 This inquiry is stated to follow on from 'corporate governance failings…[in]….BHS and Sports Direct'. ELA welcomes the Committee's wish to draw appropriate lessons from these failures but urges both that the failings are correctly identified and that the solutions address those failings.

1.3 For example, in relation to so-called excessive executive pay, in a study undertaken by PwC (Time to Listen 2016), a useful analysis was undertaken across a wider sample of jurisdictions around the world. Their study suggests that "…anger about inequality and CEO pay is primarily an expression of frustrations about job insecurity and stagnating wage growth for ordinary workers.". They further suggest that "Remarkably, there is virtually no correlation between concerns about inequality and actual levels of inequality. Indeed to the extent there is a correlation it is negative. Levels of concern about inequality are much higher in France, Italy and Spain than in the US and UK, despite levels of inequality being up to twice as great in those latter two countries.

1.4 This suggests that simply reducing top pay, and therefore inequality, may not in fact address the public's concerns." It follows that putting the issue of safeguarding worker rights and promoting worker rights higher up the agenda for board consideration is a different problem to that simply of excessive executive pay, and the two should not be confused.

1.5 However, ELA believes there are arguments to seek to altering the balance of considerations at board level, perhaps through an adjustment to the duty to promote the long-term success of the company, to ensure that boards are more accountable for taking due consideration of worker welfare and rights. ELA also believes there may well be that some form of closer engagement with the workforce, or at least representatives of the workforce, would be a welcome addition to the considerations to ensure that the board is sufficiently informed, and can take due account of worker views in making decisions.

1.6 Many of ELA's member firms operate in other countries which have worker representation at some level in companies. We have included in our response views collated from employment lawyers in those countries which we hope might usefully inform the Committee's deliberations. They highlight how the Committee's concerns have been addressed elsewhere.

1.7 ELA would caution strongly that the greater the changes to regulating existing models of corporate governance, the greater the risk of unintended consequences. If, for example, the committee concludes that workers should be represented on boards, it must be clear: what is the role of those representatives; what are their powers and duties; and, how they are to be appointed (and removed). Before recommending such a radical change to UK corporate governance, ELA suggest the Committee should be clear and state how such representatives in place would have been certain or likely to have prevented the scandals which gave rise to this inquiry.

1.8 ELA notes that UK corporate governance was extensively reviewed as part of and prior to the Companies Act 2006. ELA is not aware of any particular failings that have been identified in the operation of that Act and it would urge the Committee to review the materials generated in the relevant consultation.

1.9 Similarly, diversity on boards has been the subject of much comment in recent years. Our response draws to the Committee's attention some of the relevant material.

1.10 For this exercise, and so as to best help the Committee, ELA has structured this response according to its expertise. It has answered the Committee's questions that are within its remit, the response being structured as follows: identifying the mischief (BHS & Sports Direct); commentary on directors' duties as currently formulated in relation to worker representatives; observations on the role of worker representative generally; observations on the worker representative role in other countries; executive pay; and, diversity on boards.

2 THE RECENT BHS AND SPORTS DIRECT SCANDALS - IDENTIFYING THE "MISCHIEF"

2.1 Identifying the specific governance problems or issues which led to the negative outcomes focused upon by the BIS Committee is crucial in determining the nature of any required legal reform.

The BHS scandal

2.2 This is a particularly complex and unfortunate situation and there is no obvious single failing or common set of failings which led to the business failure and the associated pension fund deficit.

2.3 Much emphasis has been placed on the high level of dividends that were paid out in certain years, prior to financial losses which left BHS in a weaker position, together with general poor exercise of corporate governance, with various examples given. However, to some extent the nature of such failures might be characterised as bad business planning and decision making, the result of which was that BHS became a failing business. From that point, the fact that BHS might close and that the pension scheme had insufficient funds, was not a matter which could have been cured by any specific new corporate governance requirements.

2.4 ELA notes that fundamental changes to the current capitalist economic system would be required either (a) to restrict the ability of shareholders to sell their investments in failing companies or (b) to require shareholders to contribute further business funding.

2.5 It is therefore uncertain that measures, such as the following examples which have been cited as potential responses to the situation, would have resolved the issues:

(a) rules preventing directors from taking money out of a business and/or paying dividends in excess of profits and thereby removing value from the company, preventing its use for investment or pension contributions purposes.

At the time dividends were paid there appeared to be sufficient profits and the pension scheme was not in deficit. Rules requiring greater funding of the pension scheme and/or greater reserves for trading businesses might have prevented the later issues (although that is not clear), but any proposal to introduce such rules would have to weigh up the disincentive they would create for potential future investors.

(b) stronger controls requiring directors to address deficits in pension schemes, particular where there are warnings from the trustees.

Once again, at the time the deficit arose, the business was generally in a parlous position, and not able to remedy the shortfall and to continue trading. More conservative funding assumptions may have helped avoid the problems, but these largely rest on actuarial advice and the pension trustees' response to that.

(c) providing The Pensions Regulator with greater investigatory powers to act sooner than it did or requiring it to be more fast moving and proactive.

The same timing issue must be considered: at the time problems became evident the business was likely in any event not going to be able to continue to fund the pension.

2.6 ELA does not therefore consider it is in a position to identify any particular or specific new duties on the directors which would have avoided the BHS catastrophe. Tighter corporate governance aligned with better business decision making may have helped ensure the business was more successful, and thus avoided the eventual failure and pension scheme shortfall. It is possible but not inevitable or even probable that altering the scope of directors' duties along the lines we discuss in Section 3 below may have produced a different outcome. However, there are no simple or obvious legal amendments within the sphere of the UK employment law framework which would have helped avoid those problems in this particular case once the business was already on the road to failure. If regulation is to be changed to prevent another BHS then those

changes would be better implemented in a different field of law.

The Sports Direct "workhouse" issues

2.7 Distressing working conditions are acknowledged to have been a problem at Sports Direct for a significant period – for the large number of agency staff assigned to work there by the employment staffing businesses engaged by Sports Direct. These conditions included failure to pay the national minimum wage, "unfair" terms, and the imposition of a 'six strike' termination policy.

2.8 The majority of agency workers at Sports Direct were on contracts guaranteeing only 336 hours of work a year, with no obligation on the agency's part thereafter. Despite this, workers with one particular agency faced termination of their contracts if they were deemed to have refused an acceptable assignment without good cause, effectively leaving them permanently on call.

2.9 Sports Direct has now committed itself to reviewing the contracts its agencies use as part of a wider review of the organisation's practices. However, the key issue is how such practices can be generally prevented.

2.10 It could be said that the problems arose because while Sports Direct had the key commercial interest in and need to engage staff to perform work for its business, it was able to avoid and/or disclaim responsibility for those staff by the use of multiple long-term agency contracting arrangements. Those agencies were much smaller organisations with no commercial leverage, who had to accept a price from Sports Direct, and who had little interest in improving staff conditions or retention.

2.11 New corporate governance rules which impose some form of obligation or requirement upon directors to take into account not only the interests of direct employees, but those of other individuals engaged to perform work for the business (even if very indirectly) may help address the particular issues raised by the Sports Direct scandal. Such measures could be applied to all businesses of a sufficient size to exert significant commercial leverage over other organisations which may engage staff for them. There is no obvious reason why it should be limited to listed companies.

2.12 Points to consider in this context may include:

(a) The potential introduction of a similar model of required reporting as that required under the supply chain transparency obligations under the Modern Slavery Act.

This might require the directors of a company to confirm publically that basic staff conditions have been observed for all those individuals engaged to perform work within its business group. For example, a "fair treatment of workers statement" could be required to be published on company websites, confirming that all staff assigned to work for their business are on fair contractual terms and receiving the national minimum wage. The use of such a model would have particular force if applied to listed companies, which must ensure that statements to the market are accurate, but could be applied to any with a certain threshold turnover (in the same way as under the Modern Slavery Act).

(b) The application of the Conduct of Employment Agencies and Employment Businesses Regulations 2003.

Prior to amendment earlier this year there was a requirement upon employment agencies and businesses to agree written terms with their clients. It appears that this requirement was not met by the businesses supplying staff to Sports Direct. Appropriate enforcement of this obligation might have helped address many of the problems which arose. It might be that consideration should be given again to the merits of removing these obligations given the Sports Direct problems.

(c) Potential use of the proposed new labour market undertakings and orders contained within the Immigration Bill 2016 to address these types of issues.

3 DIRECTORS' DUTIES AND WORKER REPRESENTATIVES

3.1 The invitation for submissions recognizes that changes to corporate culture and governance may entail changes to the legislation concerning directors' duties. We highlight some key points raised by such potential changes, and also note the importance of codifying the rights and duties of any worker representatives on company boards.

Employee representatives

3.2 The consultation document is not clear as to whether employee representatives on boards are to be elected representatives of the nature familiar from (for example) the law of collective redundancy consultation or whether they are to be directors. In either event it will be important to demarcate their role, rights and duties. In particular:

(a) If the representatives are to be directors, it will be important to clarify what statutory and fiduciary duties they owe the company;

(b) If the representatives are not to be directors, it will be important to clarify what duties the board is under to involve them in company decision-making and in what manner. For example, an employee representative not provided with relevant papers by the board will be ill-equipped to comment meaningfully on matters under discussion;

(c) Directors owe duties of confidence to the company. Thought will need to be given as to how such duties should operate in the context of employee representatives attending board meetings. On the one hand there are strong arguments for maintaining the confidentiality of board discussions. On the other hand employee representatives precluded from informing other employees of relevant developments at all might find themselves in a challenging position;

(d) It will also be important to clarify what duties (if any) employee representatives owe to the body of employees.

3.3 Related to the above, it would clearly be desirable for government, or an independent body, to provide generic guidance to employee representatives about the nature of their role. It should not be assumed that employees appointed to boards will be aware of the intricacies of company

law. While it is to be expected that company advisers will give advice where appropriate, guidance (perhaps on the model of the ACAS codes) would be of general assistance to all concerned, including advisers themselves.

3.4 The practicalities of the position of the employee representative within the company and workforce are likely to need to be addressed by statute. At present there are statutory provisions concerning paid time off for union representatives engaged, for example, in training. There are also provisions protecting employees from certain types of related detriment. Thought will need to be given to the introduction of similar provisions for those acting as representatives on boards.

3.5 The consultation document refers to both employees and workers. We note the important distinction in employment law between employees, workers, and independent contractors. Some of the workplaces that have given rise to the greatest number of allegations of poor industrial relations practices are in fact workplaces in which there are very few employees. If the intention is to increase "worker" participation then the definitions contained in s. 230 of the Employment Rights Act 1996 should be adopted.

Duties to promote the long-term success of the company, and to have regard to employee interests

3.6 Before the passage of the 2006 Act there was debate as to whether a director's duty to promote the success of the company should encompass (or be qualified by) duties to promote long-term corporate planning and the protection of the interests of employees.[1] Section 172 of the 2006 Act represented a compromise between those in favour of legislating to change corporate behaviours, those promoting the benefits of light-touch regulation, and those concerned at the potential adverse economic effects of "political" interference in corporate governance. The overall effect of the compromise was to encourage behaviours by listing factors that directors should "have regard to". This contrasted with the more prescriptive duties contained elsewhere within Chapter 2 of Part 10 of the Act.

3.7 It is apparent that events since the Act's passage have led to debate over whether the Act struck the appropriate balance in these respects. We do not propose to enter that broad debate, but instead highlight points particularly relevant to employment law:

3.8 A problem that flows from the "have regard to" wording in s. 172 of the Act lies in the lack of clarity as to exactly how the matters to which a director is to have regard are to be balanced against the long-established fiduciary duties (including those fiduciary duties codified in the Act) which a director owes to a company. The primary obligation under s. 172 of the Act is to act in the way the director considers would be most likely to promote the success of the company for the benefit of its members as a whole. This duty, considered by the courts in hundreds of cases, is significantly more straightforward to advise on and litigate than the factors set out in s. 172(1) of the Act. There is an ensuing concern that the factors listed in s. 172 (1) have not always been afforded the importance that some proponents of company law reform had hoped

[1] See the successive reports of the Company Law Review Steering Group, notably *Modern Company Law for a Competitive Economy* (London, DTI: 2001)

for.

3.9 Equally, in an employment law context a provision that replaced the “have regard to” approach with a clear and readily enforceable set of duties owed by the individual director to the company’s employees would raise significant complexities. It would be important to clarify how these duties inter-related with long-established directors’ duties as there is an obvious potential for conflict. Notable examples would be board decisions over pay negotiations, site closures or how to approach large-scale employment disputes. While such conflicts might prove resolvable by judicial analysis we consider that it would be unwise to leave it to judges to strike the ensuing balance without a proper legislative framework as a guide. Similar considerations would apply if new "employee directors" were subject to the duty to exercise independent judgment, the duty to avoid conflicts of interest, or indeed (as noted above) other duties which a director may owe to a company. There is a danger to avoid all of these difficulties that the introduction of the role could lead to decisions being taken in a less transparent way overall, for example backroom discussions excluding the worker representative.

3.10 Practically, we note that if any new directors’ duties to be owed to employees are envisaged to be enforceable by employees themselves thought will need to be given to the forum in and method by which they will be able to do so: the overwhelming majority of current cases concerning directors’ duties are litigated in the High Court by company, creditor or office-holder claimants. Actions of that nature are unlikely to be attractive to employee litigants. We likewise consider that it would be impractical to expect employees to bring derivative actions.

4 THE ROLE OF WORKER REPRESENTATIVE

4.1 The issues highlighted above open up a broader question regarding whether a worker representative would, therefore, be the appropriate person to sit on the board and ensure this independence and cross-checking or whether, in fact, there might be other channels which could be considered akin to, for example, European Works Councils or an advisory committee; leaving the board member role to be filled by an independent party who may, perhaps be more sector-specific and have previous advisory experience.

4.2 Such a channel could for example act in an advisory capacity to the Chairman of the Remuneration Committee when it comes to decisions about Executive Pay (and the Chairman of the Remuneration Committee may be obliged to include in his director's remuneration report a section on the views of the workforce and how they have properly been taken into account when setting executive pay). They could also play an advisory role in matters of more strategic consideration which may have any material impact on the workforce. These things are starting to look increasingly like the traditional role of the Works Council in Continental Europe (which in and of themselves have significant flaws that need to be considered more widely). But they do at least focus specifically on the issue at hand – are workers' rights being sufficiently taken into account and safeguarded when boards make decisions?

4.3 The notion of a worker representative on the board would probably in any event be more fitting within certain sectors than others. For example, financial services firms subject to the senior managers’ regime may find the addition of worker representatives at board level highly problematic given the requirements of the regime.

4.4 Furthermore, there are concerns that if mandatory worker representatives on the board were viewed as disrupting the management of a business, this could lead to decisions being taken in a less transparent way overall, for example, backroom discussions excluding worker representatives taking place outside of the main board meetings.

4.5 Accordingly, there is a case for saying that mandating worker representatives on boards and / or remuneration committees should not be the government's preferred approach. The requirement is unlikely to be appropriate for all businesses across all sectors. Further, if the government's principal aims are to improve diversity on boards and curb excessive director pay, there are likely to be more appropriate ways of achieving this.

4.6 As an alternative, we return to whether there might be a statutorily mandated advisory role for a worker representative(s), with clear accountability for the board (and, in particular, the Remuneration Committee as set out above) to take views expressed properly into account, and to give reasons for their decisions in the light of those views. Such a role would mean that worker representatives (in an advisory capacity) would be able fully to express the views of, and represent, the workforce, without themselves having to balance the wider competing interests of the company (and the associated significant volumes of confidential and strategic information that would need to be considered to properly carry out that task) or risk being in breach of fiduciary duties.

4.7 This approach may also address some of the potential jurisdictional challenges (much like those currently being faced in Germany, as described below, and those currently being highlighted in the press in the UK) of worker representatives being formally appointed in the UK to represent the views of employees around the globe, particularly where the majority of the relevant group's workforce is based outside of the UK.

4.8 Discharging a more "advisory" role may de-emphasise the formality and accordingly address some of these challenges (and would not rule out the possibility of additional informal advisory representatives based in other jurisdictions also being appointed without having to address issues such as fiduciary duties and full information sharing). Consideration needs to be given to the fact that sub-board employees are not paid to take on the full weight of those responsibilities; nor may they be qualified to do so

4.9 If we are to have worker representatives on board, we would suggest that the points raised by and the views of such worker representatives would need to be noted and made available. Any minutes of meetings would also need to specifically detail how the worker representative's views have been taken into account.

5 PRACTICALITIES OF THE APPOINTMENT AND OPERATION OF WORKER REPRESENTATIVES

5.1 ELA is concerned that it is unrealistic to expect one employee to represent employees (i) with different levels of seniority; (ii) based in different locations/jurisdictions; and/or (iii) working in different business units/areas. Some sections of the workforce may be unionised and some may not. Consideration should be given as to whether companies should have the ability to allow for additional employee representatives to ensure all interests are adequately represented in a similar way to the provisions relating to the election of employee representatives in

collective redundancies or TUPE cases – see below.

5.2 Query whether there should there be a legally mandated system for selecting an employee to act as a representative? If so, will the process be similar to any of the following existing processes for electing employee representatives:

(a) (i) Under the Trade Union and Labour Relations (Consolidation) Act 1992 s188(1B)(b)(i) there is a defined election structure for choosing an appropriate worker: the employee representative is 'appointed or elected by the affected employees, who... have authority from those employees to receive information and to be consulted about the proposed dismissals on their behalf'. The election process must be carried out 'within a reasonable time' (s188(7B)). See s.188A for the more detailed election criteria.

(b) (ii) The Transfer of Undertakings (Protection of Employment) Regulations 2006 (TUPE), regulation 14 details the election process for employee representatives. The employer takes responsibility for selecting representatives, taking into account the number of employees and the various employment groups or classes they may fall into to ensure that each worker is adequately represented. The employer sets out the term of office, ensuring it is long enough for the consultation period to be completed. Affected employees can stand to be elected (though the employer may apply reasonable restrictions), and the vote is carried out on a confidential basis.

5.3 As noted above, the statutory provisions contemplate a need for several representatives. Seniority level in relation to groups or classes of employees is mentioned in TUPE. It is worth noting that junior employees may not feel able to represent the line manager, and vice versa. This is also relevant in relation to the region or business unit within which employees may carry out very different roles within companies.

5.4 There may therefore need to be legislation and specifications (or at least some guidance) as to the number and level of worker representatives and how to select sufficient workers to accurately reflect each set of employees.

5.5 Other factors to consider include:

(a) What training should the worker representative have in order to carry out the Board representative role?

(b) To the extent that companies are required to disclose information in their annual report to demonstrate how the views of the worker representative(s) were consulted and taken into account, how will this be achieved without compromising the confidentiality of the board discussions?

(c) Which employers would these rules apply to, i.e. listed companies, unincorporated, partnerships, charities? We need to ensure that the rules are not defined in such a way that large employers can avoid compliance (e.g. because they are not listed) and conversely that certain UK incorporated companies which are listed but do not necessarily have a large UK workforce are not burdened by requirements inappropriate to the scale of that workforce;

(d) Should there be specific areas on which such representatives should be consulted? If so, what should those be?; and,

(e) How would representatives interact with other statutory employee representatives (such as a European Works Council) or recognised trade unions?

5.6 It is important that worker representatives on the board (or indeed any worker representatives in general) are able to express their views and opinions without fear of retribution and, as such, adequate protections would need to be put in place to avoid workers being treated detrimentally as a result of their worker representative status. We would imagine that any such protection would be akin to that offered currently to trade union representatives and would also include paid time off for training for example.

6 WORKER REPRESENTATIVES – EXPERIENCE IN OTHER COUNTRIES

6.1 We have taken a snapshot of the different approaches taken to worker representation on boards in three Continental European jurisdictions: France, Germany and Spain.

6.2 These jurisdictions provide a reasonable sample set in the light of their distinctive approaches to the protection of worker rights and the varying states of their respective economies (and levels of unemployment) at the present time.

6.3 In only one of the three jurisdictions, Spain, was there an absence of mandatory rules relating to the appointment of worker representatives to boards / supervisory committees (albeit there is an enhanced role of the Works Council compared to the usual position in the UK). In both France and Germany, there is a legal requirement for certain types of company to appoint worker representatives to boards, with the number of representatives varying depending on the type and size of company involved.

6.4 Interesting comparisons can be made as between the different systems in France and Germany. Notably, in Germany the worker representatives play more of a traditional "non-executive" role and owe the same obligations to act in the best interests of the company as "main board" directors. The proportion of representation is also very high (up to 50% representation on the Supervisory Board, which must approve any fundamental decisions of the management of the company). In France, proportionate representation is far lower, with only one worker representative for boards of up to 12 members, and only two for boards larger than that. In that case, although the worker representatives have the same responsibilities as other board members, they typically seek to represent the best interests of the employees where they reasonably can within the wider scope of their responsibilities.

<u>The Approach in France</u>

6.5 In France, one or more worker representatives on the board is (or will shortly be) mandatory in respect of (i) certain larger listed companies; (ii) companies where employees own more than 3% of the shares and/or (iii) in State-owned companies.

6.6 The rules have been in place for a number of years in respect of the largest French companies (with more than 5,000 employees in France and a total of 10,000 employees internationally)

but they are now being phased in for smaller companies (broadly, by the end of 2017 the requirement will drop to just 5,000 employees in France, and the subsequent year it will drop to 1,000 employees in France (or 5,000 internationally)).

6.7 The requirement is that for boards with fewer than 13 members, at least one must be a worker representative. For boards of 13 or more, there must be at least two worker representatives.

6.8 For State-owned Companies, the thresholds are much lower: <200 employees – minimum of 2 worker representatives; >200 employees: 1/3 of the board must be worker representatives.

6.9 The worker representatives have access to the same information as the rest of the board and they are entitled to input on all board-related matters (not, for example, limited to executive pay or employee-related issues). The duties of the worker representatives are the same as other board members, but it is widely recognised that they will generally seek to represent the views of the employees of the Group where that is compatible with their wider obligations.

6.10 Worker representatives can be appointed in two different ways: (i) election by the employees, or (ii) designation by the (European or domestic) Works Council or Trade Union.

6.11 The duration of the appointment is determined by the Articles of Association of the Company, in the same way as for other board members.

6.12 Worker representatives on boards is, as a general concept, considered positively by companies, workers and the public more generally. Companies tend to value the perspective of the workforce when making wider board decisions and the employees feel they have a voice above and beyond the Works Council. However, there can be concerns on the Company side in respect of highly confidential or sensitive information (especially where matters of particular impact on the workforce are to be discussed); on the worker side complaints often revolve around minority representation such that, although there is the ability to put views across, ultimately the ability to influence board decisions is limited.

6.13 A key issue to note is that, notwithstanding worker representation on boards, there remains considerable press and public interest in the topic of highly paid Executives and payments for failure.

<u>The Approach in Germany</u>

6.14 Outside of the traditional Works Council arrangements (again, widely embraced in Germany, unlike in the UK) worker representation in Germany generally takes the form of membership of the "Supervisory Board". The role of the Supervisory Board is not the day-to-day management of the Company – that is the role of the "Management Board" (perhaps what in the UK would be considered to be the role of the executive (rather than non-executive) directors. Instead, the Supervisory Committee "supervises" the Management Board. In particular, it has responsibility for appointing and removing Management Board members, determining aggregate remuneration of Management Board members etc. The Supervisory Board does not take part in the day-to-day business operations of the relevant company. While the Supervisory Board's role is to supervise and advise the management board, it is mandatory for a stock corporation (AG) and common for limited liability companies (GmbH) for the Articles of Association to

contain certain reserved matters in respect of which the Management Board requires the approval of the Supervisory Board prior to taking any action. Such reserved matters often relate to issues having a significant financial or governance impact (e.g. determining budgets, entering into loans, corporate restructurings, granting of pensions etc). For listed companies, it is common that the Supervisory Board may also stipulate to the Management Board any additional items that it requires to be consulted on, before decisions are made (in each case, generally those decisions that may have a significant impact on the assets or financial situation of the company).

6.15 Not all companies are required to have a Supervisory Board, but the main company types in Germany (AG stock companies, GmbH limited liability companies and KGaA partnerships limited by shares) fall within the requirements.

6.16 For companies with more than 500 employees, a third of the members of the Supervisory Board must be worker representatives. For those with more than 2,000 employees (or, in iron, coal and steel companies only, 1,000 employees), half of the Supervisory Board members must be worker representatives.

6.17 Members of the Supervisory Board (including the worker representatives) owe the same duty of care and responsibility as the Management Board members (eg confidentiality, acting in the best interests of the company as a whole etc) – much like the current position in the UK as between executive and non-executive directors. It is, however, recognised that the duty to act in the best interests of the Company includes proper consideration of the interests of the employees of the group, internationally (and not just domestically). The worker representatives get the same voting rights as all other Supervisory Board members.

6.18 Similar to the situation in France, worker representatives are appointed in different ways, depending on the nature and size of the company in question. Generally elections are made by the employees (currently, only the employees working in Germany can vote or be elected, albeit there is an outstanding referral to the ECJ to determine whether that is compatible with EU law) or the appointment is made by delegates elected by the employees.

6.19 Appointments are for a maximum period of 5 years.

6.20 The arrangements are generally positively regarded by the workers (who effectively have co-determination rights through these arrangements and those relating to Works Councils) and the public (suggestions about moving away from co-determination rights generally attract significant negative press attention). However, the difficulties with the system are relatively well broadcast – it is time consuming and there is frequently real tension between supporting the interests of the shareholders, and the interest of the employees. Shareholders are sceptical about the system because the Supervisory Board has the power to hire and fire Management Board members and decisions may not always be taken with due regard to the interests of shareholders over the interests of workers.

6.21 However, positive aspects are also acknowledged; where difficult decisions impacting the workforce have to be taken, the "blessing" of the Supervisory Board will go a long way towards making the process more straightforward and generally accepted by the workforce. The Management Board also benefits from the insights and perspectives of the workforce when

coming to decision making.

6.22 There is a risk of concentration of too much power in the hands of one worker; usually the worker representatives are drawn from their roles on the Works Council and/or as Trade Union representatives; their views can sometimes be on the more militant side as compared to the "usual worker".

6.23 There are also potentially difficult conflicts of interest at play. On the one hand a worker representative may report to a member of the Management Board in his or her "day job"; on the other they may be required to "supervise" that member of Management Board with their Supervisory Board hat on.

6.24 Again, an important point to note is that, notwithstanding these long-standing worker representative arrangements, where workers are to a large part responsible for setting pay for, and even appointing and dismissing, members of the Management Board (the equivalent to the CEO, CFO etc) there is still considerable public outcry that both Supervisory Board and Management Board member pay is too high. This is the case even though the members of the Supervisory Board have personal liability if they are found to have granted "unreasonable remuneration" to the members of the Management Board.

The Approach in Spain

6.25 In Spain there is no requirement to have any form of worker representation on boards. The board of directors is elected by a general meeting of the shareholders, much like the current position in the UK.

6.26 However, unlike the UK, Spain has more readily embraced the concept of the domestic Works Council. The Works Council (like in many other European jurisdictions) is primarily aimed at being a consultative body, representing the views of the employees and negotiating applicable social plans and collective arrangements with the company. The Works Council owes no duties to act in the best interests of the company as a whole, nor does it owe any duties to shareholders; its purpose is to represent the interests of the employees.

6.27 There are currently no proposals in Spain to introduce a requirement to have worker representatives on boards.

7 EXECUTIVE PAY

7.1 As employment lawyers ELA members are often involved in negotiating executive service agreements, including the terms relating to remuneration. We believe that there is anecdotal evidence of executives using publically available information about director remuneration to negotiate for a more generous remuneration package. We believe this is an unintended consequence of the rules requiring disclosure of executive pay by listed companies as a result of which executive pay is escalating year on year.

8 DIVERSITY ON BOARDS

What evidence is there that more diverse company boards perform better?

8.1 A report from 2011 on the government's website sets out the case for more women on boards. https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/31480/11-745-women-on-boards.pdf The extract below gives a flavour of the reasons why gender diversity will make boards more effective. The comments apply equally in respect of wider considerations of diversity.

Inclusive and diverse boards are more likely to be effective boards, better able to understand their customers and stakeholders and to benefit from fresh perspectives, new ideas, vigorous challenge and broad experience. This in turn leads to better decision making.

This business case is backed by a growing body of evidence. Research has shown that strong stock market growth among European companies is most likely to occur where there is a higher proportion of women in senior management teams. Companies with more women on their boards were found to outperform their rivals with a 42% higher return in sales, 66% higher return on invested capital and 53% higher return on equity.

This is not just a gender numbers game. It is about the richness of the board as a whole, the combined contribution of a group of people with different skills and perspectives to offer, different experiences, backgrounds and life styles and who together are more able to consider issues in a rounded, holistic way and offer an attention to detail not seen on all male boards which often think the same way, and sometimes make poor decisions.

Of course a key factor driving boards is profitability and return to shareholders. A range of research illustrates the positive impact that women's contribution to the boardroom can make to the bottom line of the company's finances, and positively associates gender-diverse boards with improved performance.

8.2 There are a few other reports dealing with this issue, including Grant Thornton's report on the value of diversity focusing on gender diversity from September 2015. http://www.grantthornton.global/en/insights/articles/diverse-boards-in-india-uk-and-us-outperform-male-only-peers-by-us$655bn/

8.3 This article from McKinsey refers to the Lean In report which McKinsey wrote published in September 2016

http://www.mckinsey.com/business-functions/organization/our-insights/women-in-the-workplace-2016

further details below. This deals with why there are fewer women on boards and steps to address this.

<u>What more should be done to increase the number of women in executive positions on boards?</u>

8.4 The Lean In and McKinsey report from September 2016 mentioned above (https://womenintheworkplace.com/) makes some suggestions. Whilst it refers to women in all levels within organisations in the USA rather than just boards or the C-suite, it looks at barriers and steps to address those which would equally apply at the board level. It lists four areas of focus to improve gender diversity: (*1) Make a compelling case for gender diversity. (2) Ensure*

that hiring, promotions, and reviews are fair. (3) Invest in more employee training. (4) Focus on accountability and results.

8.5 This KPMG report from October 2015

https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/482059/BIS-15-585-women-on-boards-davies-review-5-year-summary-october-2015.pdf

summarised the business case for gender diversity on boards: selecting from the whole talent pool, competing for talent in the global stage, being more responsive to customers and stakeholders, modernising British business and reputation, benefiting from diverse perspectives and improving all round performance. Their checklist for improving gender balance on boards includes the following:

(a) collect and analyse relevant data (this includes not just analysing the gender split throughout the organisation but also by reference to key clients and roles to assess whether women are getting the right experiences);

(b) seek feedback, monitor the data and reward progress (including asking for feedback from women in the business, from exit interviews, set realistic targets, hold senior management to account for progress, monitor action plans at executive and board level and seek out best practice from other organisations);

(c) recognise unconscious bias and implement training;

(d) evaluate recruitment processes (include separate evaluation into performance appraisals to seek to eliminate bias) and encourage flexible working (including taking shared parental leave) of both genders showcasing examples; and

(e) develop smart talent management to profile women (engaging men in the process, have senior management as sponsors for high potential women, set up formal mentoring programmes, set up cross-organisation networks and encouraging women to go for board appointments).

The report concludes that quotas are unwarranted, focusing instead on a voluntary business-led approach over 5 years across the FTSE 350. It looks for listed companies to set realistic, stretching targets for women on boards to drive progress (e.g. 33% on boards). It encourages the focus to be on targets on women taking up chair and senior independent director roles and executive director positions. The report also suggests an independent steering body to assist business, made up of business and subject matter experts to act as a catalyst for change, monitor the situation and report periodically.

8.6 In addition, there is a Harvard Alumni study from September 2016

https://www.alumni.hbs.edu/stories/Pages/story-bulletin.aspx?num=5788

which talks about what women can do to put themselves in the best position for a board role.

8.7 There are some interesting ideas from this paper

https://www.egonzehnder.com/files/ez-bc-seven_steps_to_board_diversity.pdf

including: diversity must be a board priority, assess nomination processes, look at the board culture, leverage the focus on board composition (e.g. use the fact activist and institutional shareholders are looking for changes in boards so their skills and experience are aligned with the company's strategy to push forward diversity on boards); have a solid on-boarding process and work on the leadership pipeline (addressing issues such as work-life balance and unconscious bias to ensure there are more women in senior positions below board level so they are well positioned for a board appointment).

8.8 McKinsey's report 'Diversity Matters' February 2015 http://www.diversitas.co.nz/Portals/25/Docs/Diversity%20Matters.pdf where they comment:

For every 10 per cent elevation in ethnic diversity in the executive leadership of US companies, there was a 0.8 per cent improvement in EBIT. Cumulatively, more racially diverse companies had better financial performance: companies in the top quartile for ethnic diversity in leadership in leadership roles had a higher probability of above-average performance than those in the bottom quartile (Exhibit 6).

ELA Working Party

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