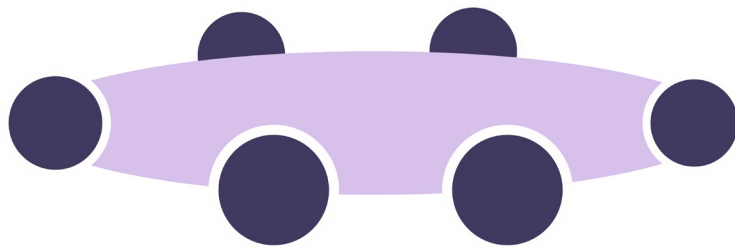


Bringing employee voice into the boardroom

A practical and flexible way forward



tomorrow's
company

Executive Summary

25 years on from the Cadbury report there have been many technical improvements to governance, from director independence to the audit process. Yet, in spite of all these reforms, and the cumulative compliance burden that directors feel has accompanied them, there is a growing gap between those at the top of businesses and ordinary people. Contributing to this are excessive levels of executive pay, stagnating real-wage growth, recurring scandals, low investment and low productivity.

The patience of the public, and those who represent them in Parliament, with what they perceive as corporate irresponsibility, is now exhausted. In this context, the government has announced a clear intention to reform corporate governance. Change looks increasingly inevitable. The test of that change over the next few years will be how far it stimulates a change in culture, and a move towards behaviours that genuinely, in the Prime Minister's words, address the interest of the many not just the few.

It is easier to change structures than to change cultures. In this paper Tomorrow's Company draws on dialogues with business leaders, investors and other stakeholders to suggest a practical way forward. In doing so, we recommend that the government insists that large companies take action, but allows them to choose from a range of different options as appropriate to their circumstances, and allows time to experiment and prepare. Reforms need to reinforce the good business practice that currently exists, encourage change where needed and avoid placing a burden on all companies.

On their own, provisions to introduce employee directors cannot solve all the many problems which we have identified in our recent report [UK Business: What's Wrong? What's Next?](#) and associated research. To be effective the proposed reforms should be supported by a broader range of government policies and, crucially, they need to reinforce rather than dampen the voluntary initiatives of boards, business leaders and institutional investors.

There is a danger that the debate on employee directors will take place in a negative spirit. The aim of the exercise is to enhance the voice of employees within company governance so that better decisions are made in the long term interests of the company and all those who depend on it. Little will be achieved if the debate gets stuck in the predictable territory of curbing executive pay or redressing imbalances of power between employees and shareholders. In our recent UK dialogues and research into the experience of European participants we have concluded that better employee representation can improve the quality of decision-making by bringing a different perspective and information set to the board.

There are many different ways in which this can be done. For example, some companies are introducing arrangements outside the boardroom which are targeted at engaging and hearing from younger employees. Others are strengthening employee ownership arrangements. We talked to directors with experience of continental Europe who told us how, after initial difficulties of adjustment, the formal appointment of employee directors has improved decision-making.

The benefits of listening to employees and engaging them in both consultation and decision-making are already widely recognised and standard practice in many companies. Furthermore, the UK has a strong and growing employee ownership sector. Wherever employees are also shareholders there is a natural channel for representation where conflicts of interest between shareholders and employees are more easily dealt with. As part of its move to encourage employee representation, the government should reconsider how it can promote employee ownership in both its individual and collective forms. This and other sectors outside the traditional listed company offer many experiences from which to learn.

Too often in the UK business world we have responded to the positive examples of employee representation in Europe by saying that this would never work here. We need to be more open minded. Experience and research suggest that increasing the voice of employees within and around governance structures can be a powerful way to help create a sense of shared purpose, reinforce alignment between employees and shareholders, and better manage risk by providing constructive challenge to the executives and boardroom.

It is vital that the government does not deal with proposals for employee directors in isolation. Reforms should reinforce the principle of the unitary board and the indivisible nature of directors' duties. Directors of companies are not representatives of interest groups, be they employees, shareholders or other stakeholders. They owe their duty to the company. Section 172 of the 2006 Companies Act says that they are there to promote its success to the benefit of its members (shareholders) as a whole.

This raises a wider question: since its introduction has Section 172 of the 2006 Companies Act made enough difference to decision-making? Opinions vary as to whether boards are genuinely 'having regard' to the interests of employees and other stakeholders as required by the Act, and how this might be enforced. One way of underpinning Section 172 might be to introduce a Corporate Advisory Panel on which various different stakeholders, not only employees, might be represented. In her speech on employee directors, the Prime Minister made a brief reference to customers. In this document, we have not looked beyond the employee as stakeholder. In future work we do plan to consider this wider issue. We recommend that before settling on any change in arrangements for employee directors the Government works out where it stands on other stakeholders and on the effectiveness of Section 172.

By the same token it is important to ensure that these reforms support existing efforts to improve the gender and ethnic diversity of boardrooms. One learning from the diversity debate is the need to catalyse a cultural shift in the boardroom, something that the appointment of one isolated individual may not achieve.

For all these reasons we propose that the government takes a flexible approach to strengthening employee voice, which would also be in keeping with the UK's tradition on corporate governance. The options proposed in this paper allow for differences in the current culture and organisational structure of companies, their ownership, and the extent of their international operations.

This paper is by no means exhaustive, but is intended to start a pragmatic discussion on how companies can increase employee voice within governance structures in a manner that helps build public trust and supports long-term business success. Further work would be needed to work out the specific details of the proposals.

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Proposal

One option incorporates employees as insiders. The other gives them a powerful channel of communication and challenge as outsiders based on some form of employee advisory panel.

While offering companies flexibility it would apply to all companies with more than 500 employees in the UK. (This is 3,100 companies who employ 8.6m people - 35% of private sector employment). These companies would be required to demonstrate that they offered effective employee voice within governance structures. This could either be demonstrated by the formal introduction onto the board of one or more employee directors, or by the use of employee consultative structures outside the board. In both cases the company would be required to report on how its arrangements achieved employee voice. In the case of the second 'outside' option the company would be required to give the employee advisory panel an opportunity to report publicly on its activities and its views of the effectiveness of the arrangements at the AGM, in the Annual report, and on the website. There would be a transition period of two years during which the principle of 'comply or explain' would apply, as companies start to experiment with either option and explain what they are doing.

Companies with more than 50% of employees in the UK would be required to demonstrate employee voice at the group level, while those below 50% would have the option to demonstrate employee voice at the UK subsidiary level, most likely under option 2.

Option 1 – Employee directors on a unitary board – Introduce employee representatives onto the board, where importantly they have the same legal duties and responsibilities as other directors. This duty is to the company not to employees or shareholders. There are three ways the directors can be elected.

- Directly elected by employees in the same way employer's pension scheme members elect their representatives.
- Appointed by an employee advisory panel that is in turn elected by employees.
- Appointed by an employee ownership trust that has a significant shareholding in the company, held on employees' behalf.

Option 2 – Employee advisory panel – Introduce (or, where it already exists, formalise) an elected employee advisory panel that meets regularly and then has formal channels of communication to the board. In order to ensure that this option has teeth, the panel would be empowered by giving it the right to report publicly its views on key issues facing the company, including executive pay. This could be published in the annual report and a summary of its conclusions would be presented by the panel chairman at the AGM.

For subsidiaries of multinationals the advisory panel would communicate regularly with the UK management board of the company with an annual report or presentation provided to the group level board.

Under either of the above options, different methods might need to apply where a significant proportion of the workforce were represented by a recognised trade union. The principles would remain the same, and, as is the case in continental Europe, an employee director nominated by a trade union would owe undiluted loyalty to the company.

The first question for the advisory panel's commentary under any of these options is how well the company has fulfilled the letter and the spirit of the government's new provisions. This would create an internal dynamic, based on transparency, which would reduce dependence on any external inspection.

1. Introduction

Theresa May has made a prominent pledge to reform corporate governance. As part of this she has suggested a requirement to introduce employee representatives on boards. Following on from this, the BEIS Select Committee has announced a consultation and a government green paper is expected shortly. Both initiatives reflect a growing public sense that businesses are not properly serving the longer term interests of shareholders or society, and that something needs to be done to rebuild public trust in business. Change looks increasingly inevitable.

Efforts to introduce employee directors date back to the 1977 Bullock Report on industrial democracy. More recently, employee voice on remuneration committees featured in both the Labour and Liberal Democrat 2015 manifestos and a 2013 Private Members' Bill. This discussion paper examines the need for employee voice in the boardroom and, by setting out a range of options, suggests a way of making this work in the UK.

"The genie is now out of the bottle, it's no longer a case of if but when" Good Governance Forum attendee

"[I'm] all for having more worker consultation, but the best way to do that is not necessarily to put a single worker on the board" Sir Vince Cable

"Placing workers on boards can bring benefits in terms of better employee engagement, and we would urge companies to consider doing so, although we would stop short of making it compulsory for firms." Oliver Parry, IoD

"Employee representation on boards is an opportunity to drive common sense into executive remuneration packages" Good Governance Forum attendee

"The presence of employee directors on the FirstGroup board is invaluable. The few drawbacks are greatly outweighed by the benefits and having this two-way channel of communication has positively impacted on the running of FirstGroup." Martin Gilbert, former Chair of FirstGroup

"Countries that allow workers to play a stronger role in companies have benefited from greater investment in research and development, and lower rates of poverty and inequality." Frances O'Grady, General Secretary TUC

"We believe that greater engagement with employees may help restrain executive pay and help mitigate negative impacts on morale as well as encourage a greater engagement with the workforce. We therefore call for employees to be represented on remuneration committees as a first step to better engagement and accountability." High Pay Commission

"To restore greater fairness, we will be consulting on new measures to tackle corporate irresponsibility. These will include cracking down on excessive corporate pay, poor corporate governance, short-termism and aggressive tax avoidance – and giving employees and customers representation on company boards." Prime Minister Theresa May

2. The growing need for employee voice on boards

Tomorrow's Company has always argued that the key to enduring business success lies in clear purpose and values, which permeate all relationships, thereby creating alignment and a foundation for trust, loyalty and commitment. A strengthening of employee voice is a key part of this. The 2012 report "[Rethinking Voice](#)" demonstrated how it can lead to deeper employee engagement, enhance decision making and drive innovation. The importance of actively listening and involving colleagues in decision-making, not just allowing staff to express their opinions, is now widely accepted by businesses as crucial for success. Increasing employee voice in and around governance structures can help reinforce this approach.

There is also a growing recognition that to rebuild public trust in business, boards of directors need to listen and be responsive to a wider group of stakeholders beyond shareholders. Tomorrow's Company believes that incorporating employee voice into corporate governance is an important element in overcoming the shortcomings of UK business, as identified in our 2016 report [UK Business: What's Wrong? What's Next?](#) and subsequent research. We cite:

1) Poor outcomes for stakeholders, including shareholders. The UK has low employee engagement, low real-wage growth, low productivity, low investment and low public trust in business. The irony is that shareholder returns have also been poor. The 20-year real-return on UK equities is now the same as government bonds, the first time since the Great Depression.

2) Rising executive pay is eroding trust in business. Executive pay has risen far in excess of returns to shareholders, profits and employee wages. In the UK, the ratio of executive to average worker pay has increased from 47 to 148 times between 1998 and 2014.¹ It is no surprise that surveys show executive pay is one of the top issues eroding public trust in business. There is also evidence that it is demotivating employees – a CIPD report in 2015 found that 60% of employees think CEO pay levels are demotivating.²

3) Boardrooms remain relatively homogenous. The Higgs Report (2003) found that non-executive directors' recruitment onto boards was largely through personal contacts from the same social and professional backgrounds as executive directors. Since then progress has unfortunately been limited. Ethnic diversity has stagnated for two decades behind gender diversity, with Black, Asian and minority ethnic (BAME) representation on boards remaining at 5 percent of FTSE 150 companies³. While female representation on boards has increased since the Davies review, there are still just 7 female CEOs and 4 chairs in FTSE 100.⁴

4) This homogeneity makes them less open to innovation. Boards place too much focus on downside risk, not innovation. Listed company boardrooms have in general become risk averse, focusing on the short-term benefits of cost cutting, rather than the long-term returns of investment. This has contributed to innovation increasingly coming from outside the listed sector.

5) Effective oversight by NEDs has proved elusive. Despite continual improvements to good governance practice, NEDs continue to find difficulty getting to the relevant information in the available time. The nomination process remains relatively closed. There have been examples of shortcomings in the listed sector, such as Sports Direct, and in the private sector, such as BHS. NEDs have reported that where a major decision on an acquisition has to be taken, they are confronted with a fait accompli and given little choice in shaping the decision.

5) The corporate world is being turned upside down by the wide availability of information. In a world of social media, boards need to be far more responsive and promote greater agility in the organisations of which they are stewards. Engaging those who are close to the innovation and closer to the customers offers the board better antennae.

3. Benefits and challenges

In order to explore the proposal for an active employee voice at board level, Tomorrow's Company recently invited the members of its Good Governance Forum to discuss whether there should be employee directors and how this might be achieved. This group included UK institutional investors, company secretaries, NEDs, chairmen, directors and senior representatives of Norwegian and German organisations, and board consultants. Below are the main arguments for and against the introduction in the UK of employee directors.

Arguments for employee voice at board level:

- **Co-ownership and trust** – Employees on boards could create a sense of co-ownership and trust, enabling board members to engage and listen to employees. This may lead to improved employee satisfaction and reduced turnover. This is especially important given the increasing evidence of the link between employee engagement and productivity. This can help with the alignment between a company's values and culture.
- **Knowledge and insight** – With comprehensive knowledge of day-to-day operations, employee representatives may increase the flow and quality of information, which could improve decision-making by the board.⁵
- **Providing contrarian view** – Improving the diversity and background of board members may lead to more challenge and a contrarian view, helping to avoid board 'group-think'. The majority of information that boards currently receive is from the executives; one or more employee representatives could enhance the ability of non-executive directors to challenge the executives.
- **Long-term view** – As employee interests are usually aligned with the long-term success of the company, such a change may encourage longer-term decision-making that is in the interests of long-term shareholders.
- **Curbing excessive pay** - Employees might act as a monitor and counterbalance to excessive executive remuneration, which may help close the gap between executive and average worker pay.
- **Connecting with customers** – Many employees are closer to customers and therefore their participation on the board may help increase the focus on customers. This is important for many reasons, particularly innovation and customer responsiveness.
- **Enhancing Corporate Social Responsibility** – Employee representatives may help a board understand broader societal concerns and enhance its ability to operate in a socially responsible manner. A study of Danish companies found that employee representatives are more likely to take into account environmental and community interest than shareholder representatives.⁶
- **Embedding values** – as described in the recent [Governing Culture](#) publication, the board is key in setting and maintaining the desired culture and employee voice may enable boards to embed values throughout the organisation.

Arguments against employee voice at board level:

- **Legal duty versus loyalty to employees** – There may be a tension between an employee's loyalty to colleagues versus the legal duty of directors. The members of the Good Governance Forum were clear that like all directors, employee directors should owe their duty to the company. To deviate from this would be to move away from a unitary board. It was noted that in many other European countries employee representatives have the same duties as other directors and this works well.
- **Lack of skills and experience** – Space on a unitary board is limited. Each director needs to bring a set of skills and experience that add to the effectiveness of the board. Using some of the board spaces for employee directors may be considered an opportunity cost given someone with more experience may have occupied those seats. To help overcome this companies would need to ensure employee directors had the time and resources for sufficient training and induction. The value of an employee director may be to ask the difficult question, rather than bring a detailed understanding of corporate affairs.

- **Legal liability** – Given the probable lack of board level experience it could be unfair to hold an employee director liable for a range of decisions that are beyond their skill and experience.
- **Undermining the rights of shareholders** – Employee directors, elected and appointed by employees, could undermine the right of owners to elect who runs the companies they own. However, those with experience of employee directors told us that this objection cannot apply where all directors owe their duty to the company, not one specific stakeholder group. It was also important to have an appropriate limit to the number of employee directors on the board.
- **Lonely voice** – A single employee on a board may not make much difference, as they may be ignored or outvoted by dominant shareholder elected directors. This in turn could lead to resentment and damage to employee relationships. This may be felt to be an argument for introducing more than a single representative, or supporting them with an employee panel.
- **Inability to represent a diverse organisation** – A single employee representative may struggle to represent employees in an organisation with diverse operations. For example, some organisations have a homogenous workforce while others have diverse operations with different business units in disperse locations. This can be dealt with in a number of ways. Firstly, the representative can be given sufficient time to travel around and visit the different operations. Second, as suggested below the representative could be supported by an employee advisory panel. Thirdly, in companies with recognised trade unions, unions can support two-way communication with the whole workforce.
- **Confidentiality** – Concerns were raised over the leaking of confidential conversations and papers. Experience from employee representation in Europe suggests that this may not be such a significant issue. A study of German companies found that there are very few cases of confidentiality violations⁷ and a survey of Irish companies found that “almost all respondents stated that they had never heard of a breach of confidentiality or conflict of interest in relation to worker directors”⁸. Norwegian and German guests at the Good Governance Forum observed that in their countries breaches were more often from shareholder representatives and confidentiality has never been a significant issue. TUC research found that employee directors have a variety of strategies available to ensure that they comply with the confidentiality while still reporting to and engaging colleagues.⁹

Overall the balance of arguments in the Tomorrow’s Company dialogue was strongly in favour of increasing employee voice within governance structures. The election of employee directors was seen as one means of achieving this. The benefits are not just about enhancing trust between employees and management, but also from bringing a different perspective and information set that improves the quality of all board decisions. Listening to and engaging with employees has become part of good business practice. Increasing employee voice in governance structures should be seen as a means to further reinforce this, rather than as a means to change the balance of power between stakeholders. Alongside this, those with experience suggested it was possible to overcome the key arguments against, such as confidentiality.

There is also rising awareness of the importance of culture in the success of a company, reflected most recently in the work of the FRC’s Culture Coalition. The introduction of stronger employee voice in or around the boardroom can strengthen the board’s ability to keep its finger on the pulse.

4. Evidence and examples

There are a multitude of factors that influence company performance. It is almost impossible to isolate the impact of employee directors. Nonetheless there is a range of evidence that suggests they can have a positive influence. This broadly draws on the experience in continental Europe where 19 countries have representation on boards. There are various different approaches and examples. Some come from unitary and some from two-tier board structures.

The TUC report '[Workers on Boards](#)' cites a number of studies supporting the proposal, a few are highlighted below. A study by Vitols (2005) comparing EU countries with strong and weak codetermination pointed to a number of positive correlations. Most stark is the average number of working days lost to strike action. One study showed that between 2000 and 2002, in countries with strong rights for codetermination this was 9.7 days per 1000 workers. In countries with limited or no rights it was 104.8. Using the Gini coefficient, a measure of inequality, it can also be shown that countries with greater equality are those with stronger worker representation rights (0.259 vs 0.321).¹⁰ While recognising that there are a number of factors which may contribute to economic success, and that correlation does not prove causality, there is a basis for believing the proposal could, over time, lead to positive outcomes.

At a national level, analysis by the TUC found that countries with stronger participation rights performed better in terms of "R&D expenditure, employment rates, educational participation among young people and educational achievement among older workers."¹¹

A study in the Journal of Financial Economics found that in Germany employee representation reduces agency costs and increases the firm value. This study found that there was an optimal level of employee representation beyond which it reduced firm value. They also found that industries that "require more intense coordination, integration of activities, and information sharing" benefit the most from employee board representation. The paper cautions that when "employee representation reaches an excessive level, labour itself may become the source of an agency cost as employees seek their own perks"¹².

Studies looking at the link between performance and employee representatives naturally face statistical issues of identification and causality. Therefore, more compelling are the surveys which find that executives and board members who have worked with employee representatives give a positive response. A survey in Sweden in 2001 found that 61% of managing directors and 69% of chairpersons described the impact of employee representatives as positive.¹³ This echoes the views expressed in Tomorrow's Company dialogues by German and Nordic representatives.

Another compelling body of evidence is on the benefits of employee voice. Much of this is captured in the MacLeod Report, [Engaging for Success](#), or in the joint report between Tomorrow's Company and the IPA (The Involvement and Participation Association), [Rethinking Voice](#).

First Group is the only UK example of a listed company with a non-executive employee director. It has had one since its founding in 1989. The group's annual report describes it as "extremely beneficial for its employees to be represented on the Board in this way as it enables employee-related issues to be raised directly at the Board and provides a two-way communication between the Board and employees."¹⁴ Each UK subsidiary of the company has an employee director, forming an Employee Directors' forum, which elects one person to the group board.

In the Republic of Ireland, employee representatives, known as "worker directors", sit on single-tier boards of state-owned enterprises, accounting for one third of the total board. Worker directors have the same rights and duties as ordinary directors, and candidates are nominated by unions and elected by the whole workforce.

5. How could this be adopted in the UK

In Tomorrow's Company dialogues there has been broad agreement that we need to increase the voice of employees within governance structures. This sentiment is shared across many in the business and investment community. Given the new focus of the government, the question becomes 'how' this is achieved, rather than 'if' this should be achieved.

It is important to recognise that increasing employee voice within governance structures is just one means to address some of the current failings of company governance. To be effective it needs to be part of a wider agenda that, amongst other things, supports stewardship through the investment chain, encourages investment and tackles executive pay. Tomorrow's Company is working on these broader policy areas through its other projects including a study which it is currently undertaking for the All-Party Parliamentary Group on Corporate Governance.

In the same way government will need to make a systemic connection between any proposals for employee directors, and its own treatment of related issues. The Prime Minister touched on this when, in her discussion of the desirability of employee directors, she also spoke about the representation of customers.

It will be impossible to change policy in this area without reviewing the current position on directors' duties. Section 172 of the 2006 Companies Act says that directors are there to promote its success and the benefit of its members (shareholders) as a whole.

172 Duty to promote the success of the company

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

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

Opinions vary as to whether boards today are genuinely having regard to the long term or the interests of employees and other stakeholders as required by the Act. If the government decides that the current wording is not being fully applied in boardrooms, then it will need to consider how Section 172 might be given more force. One way of doing this especially in the largest companies might be to go beyond the creation of an Employee Advisory Panel, as described in our proposal here, and require companies to set up a wider Corporate Advisory Panel on which various different stakeholders, not only employees, might be represented. In this document, we have not looked beyond the employee as stakeholder. In future work we do plan to consider this wider issue. We recommend that before settling on any change in arrangements for employee directors the Government works out where it stands on other stakeholders and their representation and how its proposals on each might be linked in a logical way to each other and to the legal definition of Directors Duties.

By the same token it is important to ensure that these reforms encourage rather than discourage voluntary innovation and improvement by companies. For example, we have spoken to companies which are currently considering ways of empowering the voice of the next generation within the company and its decision-making. Equally any reforms need to support existing efforts to improve the gender and ethnic diversity of boardrooms. One learning from the diversity debate is the need to catalyse a cultural shift, rather than appoint a single isolated individual.

One benefit of employee voice may be to control excesses in executive pay, but this is not the sole purpose. If employee representatives were placed only on the remuneration committee this on its own would fail to capture the other benefits such as increasing the diversity of viewpoints on the board. Equally the growth of a culture of shared reward through a concentrated focus on increasing employee share ownership and profit sharing could be a far more effective and constructive way of tackling inequalities of reward within an organisation.

It is also important to recognise the patience that is needed if structural change is to be followed by lasting cultural change. Many dialogue participants told us how they had been convinced over time of the value of employee representation, as the culture slowly changed. We should not expect reforms to achieve success immediately. Research studies point to a 'learning effect' of works councils where adversarial relationships decrease and productivity increases the longer the council has existed.¹⁵

There would need to be a transition period to allow companies to introduce new structures or adjust current ones. During this period there could be a 'comply or explain' approach. There may also be a case for a more phased approach where ahead of any legislative change a small group of companies could be encouraged to trial various options.

Most objections to the idea of employee representatives are based on the fear of a blanket approach being imposed on all companies. People worry that a knee-jerk response to appease public discontent may result in a number of unintended consequences. Tomorrow's Company believes that the most sensible way forward may be to allow companies flexibility on how they increase employee voice within governance structures. This would also be in tune with the UK's long history of driving innovation in corporate governance through flexibility.

A further reason for flexibility is that the right approach depends on each company and industry. A single employee representative on the board could work well for a company with a relatively homogenous workforce. For example, First Group has 17,500 employees. Of these 13,540 are drivers, and so a single representative can be effective. In contrast, in a company with diverse operations a single employee may struggle to represent all employees: it could be better served by an employee advisory panel which then nominates one or more individuals to the board. As highlighted below, another key difference is the proportion of workers that are in the UK.

While it is right to offer large companies operating in the UK choice in the approach they take, the reforms still need to have teeth. There is nothing in UK company law to prevent companies introducing employee representation in the boardroom, yet only one FTSE 250 company has chosen to do so. Many executives and chairman will instinctively resist the idea of a potentially disruptive voice on the board.

In light of this, Tomorrow's Company proposes that companies are required to have effective employee voice within governance structures, but are given flexibility on how. A guide could be published with the various options and rationale for why each one would be suitable. Then each company could provide an explanation as to which approach they have chosen and why. This approach will enable companies to innovate and reduce the burden on companies that are already actively engaging and listening to employees.

Tomorrow's Company proposes two broad options, each with a few sub-options. Companies can either introduce employee representatives as insiders within governance structures, making them privy to all information and having the same legal rights and responsibilities as other directors. Or companies can increase the voice of employees as outsiders with an employee advisory panel that has formal communication channels to the board and the mandate to publish an annual statement. As part of this there need to be an option for UK subsidiaries of multinational companies where group level representation of UK employees may not be appropriate.

Companies would be required to state in their annual report and on their website how they have incorporated employee voice in their governance structures and why.

What companies does this apply to?

Before outlining the options, it is worth starting with some key statistics on UK companies and employment.

- UK private sector employment is 25.8m, out of 32m total employment.¹⁶
- FTSE100 companies employ 6.5m people globally.¹⁷ Of these 2.2m work in the UK, 9% of private sector employment, and 34% of FTSE100 employment.¹⁸ Within this there is a significant range:
 - Vodafone employs 111,684 people, only 13,323 (12%) are in the UK (end March 2016).¹⁹
 - Tesco employs 357,835, of these 225,371 were in the UK and Ireland (63%), (end February 2016).²⁰
 - G4S employs 611,366, of these 35,843 were in the UK and Ireland (6%), (end 2015).
 - Antofagasta employs 5,300 people who work alongside 13,900 contractors. It only reports 5 employees working in the UK (end 2015).²¹
 - Anglo American employs 91,000 people, of which only 2,000 work in Europe (end 2015).²²
- There are 1,300 listed companies in the UK that employ 3.7m people. 14% of private sector employment.²³
- There are 3,380 companies in the UK that employ more than 500 employees. In total these employ 9.0m people, 35% of total private sector employment.²⁴
- Union membership for private sector employees is now 2.7m, or 10% of total private sector employment. 16% of private sector employees pay is covered by collective agreements with a trade union.²⁵

In the light of this data there are three key conclusions to be drawn. First, to make a meaningful impact the reform needs to apply to all companies with more than 500 employees. If government were only to apply reforms to listed companies, this would only affect 14% of private sector employees. Secondly, UK companies have significant global operations and therefore imposing increased employee voice across the whole of a multinational company may be inappropriate and overly onerous. Thirdly, there are a significant number of UK companies that are subsidiaries of foreign multinationals. There need to be separate options for group level representation in predominantly UK-based companies, and an option for subsidiary level representation in multinational companies.

The proposal is that these reforms only apply to UK companies with more than 500 employees working in the UK. This would be irrespective of ownership structure, whether companies are private, listed, employee owned or the subsidiary of a foreign multinational. For these companies there would then be a choice between employee voice at the group level of the company, or in the UK subsidiary of either a UK or foreign multinational. The subsidiary option would be available for companies where UK employees make up less than 50% of the total. These options are outlined below, with option 2 being relevant for subsidiaries.

Some companies are heavily reliant on collaborative partnerships, long term contractor relationships, and outsourced functions. Here it would be left to the company's discretion if they included these individuals in their employee voice structures.

Due respect needs to be given to existing trade union arrangements, and where trade unions are recognised as the representative channel, the legislation needs to be framed in ways that are aligned with, rather than cut across these established arrangements.

Option 1 - Employee directors on a unitary board

The first option is to have 1-3 employee representatives on the main board. They would have the same rights, responsibilities (including confidentiality), duties and remuneration as other directors. They would attend all board meetings, receive papers and have equal voice and voting rights on issues. Importantly, this means the employee directors are there on an equal basis with other directors and owe their duty to the company, rather than only to employees. This is how employee representatives work in many European and Nordic countries. Employee representatives bring a different perspective, while not compromising the concept of a unitary board.

As well as sitting on the main board the employee directors may be nominated to join sub-committees. Companies may in particular want employee directors to join the remuneration committee, given the desirability of taking a whole-company view of remuneration.

Options for nomination and appointment:

1) Elected by employees

Employee representatives could be elected to the board in the same way that pension trustees are elected. Employees can be nominated as candidates, then there would be an election across all employees in the company. This could be conducted purely with manifestos, or also with hustings.

Employee representatives could be elected straight to the board as happens in many European countries. However, this would require a change to UK company law. One alternative would be for an election process that nominates an employee representative to the board, who is then appointed within the current system of a shareholder vote at the AGM. For the employee representative the vote at the AGM would, in large part, be a formality. This would avoid the need for a significant change to UK company law.

2) Appointed by an employee advisory panel

An employee advisory panel could be elected in the same way that a representative would be elected to the board. The advisory panel could then nominate 1-3 people to be the representative on the board. The advisory panel would meet regularly to discuss the issues which should then be communicated to the board via their nominated representative.

Only the board directors would have access to board papers. The board could choose to disclose additional information to the panel, in which case all members would be bound by confidentiality.

This option may be more suitable to a company with diverse operations where a single representative may struggle to represent the whole workforce.

3) Represent an employee ownership trust

To increase alignment and provide a greater mandate, the employee representative could be nominated by an employee ownership trust. Many companies already have trusts that own shares in the company on behalf of employees. For example, Handelsbanken has an employee-owned foundation that owns 10% of the company. See a case study here in [Tomorrow's Business Forms](#). To be effective this would need to be a trust in which, after a qualifying period, all employees participated or stood to benefit on a long-term basis.

The representative could still be elected by all employees as in option 1, but would sit on the board both as an employee representative and as a significant shareholder. This could help create alignment between the interests of employees and shareholders.

There are already a number of companies where employee ownership is integral to their success. It helps create a collaborative culture and aligns employees with the interests of long-term shareholders. There are many examples, two of which are TTP and Unipart, for which there are case studies [here](#).

There is also evidence for the benefits of employee ownership. For example, an index of UK listed companies that have greater than 3% employee ownership has outperformed the FTSE All Share by 14% since 2003.²⁶

This option has the potential to deliver the greatest benefits as it incorporates employee voice into the boardroom while aligning the interests of employees and shareholders. This in turn can help build a culture that supports the company's long-term success.

Other aspects to be considered:

- **Time commitment** – The time commitment for a typical non-executive director is 30-40 days a year. An employee representative would need to negotiate reduced hours for their job in order to carry out the role effectively. A time allocation could also be considered to allow time to travel and meet employees throughout the organisation.
- **Induction and training** – Like all directors, employee representatives would need significant induction and training that is tailored to their previous experience to operate effectively on a board. Sufficient training should be required within reforms.
- **Public disagreement** – In the case where an employee representative disagrees with a board decision, there is a question of whether and at what stage they should be able to state this publicly. In one example given, the board would discuss and approve a statement that could be made public. Tomorrow's Company has recommended that all boards go through a process of defining the [Board Mandate](#) and this issue could be usefully anticipated and handled as part of the board mandate process. Like other board members, an employee director may also tender their resignation as an option of last resort.
- **Communication to employees** – Employees would expect an employee director to communicate with them. Yet this needs to be done without compromising the principle that the employee director owes a duty to the company, not to employees. For instance, following the development of the board mandate, in partnership with the chairman or general counsel the employee director could clarify what can be communicated, circulate a newsletter to staff, hold an online Q&A, present at the AGM or publish an annual statement agreed with the board. This process for communication to employees will depend on the process of nomination and appointment. Where the employee director's appointment comes via the Employee Advisory Panel or the Employee Shareholding Trust, the feedback may naturally flow through this route. Where there is a recognised union channel, this may also be used.

Option 2 – Employee advisory panel

The alternative to making employees insiders within governance structures is to give them more voice and power as outsiders. Companies could introduce an elected employee advisory panel that would meet regularly, have a formal channel of communication to the board and would publish an annual statement with its view on key issues.

The aim would not be to create an antagonistic relationship between the board and employees. Ideally the advisory panel would form a constructive two-way dialogue with the board. For instance, once a year a joint meeting could be held between the advisory panel and the board. The ability of the advisory panel to make a public statement under the options considered below would underpin their voice and ensure that board members engaged with the issues raised.

Too often boardrooms only receive information and hear the story told by the executives. An employee advisory panel, with a legally protected position, could help provide the board with a wider view of operations and strategy and benefit from many of the upsides detailed in section 3.

The benefits of an advisory panel go beyond balancing employees versus other stakeholders. They can also play a positive role in innovation. Employees are often much closer to customers and therefore in a better place to think of new customer solutions. The main board could ask the panel to look into certain issues on which it is looking for fresh ideas.

Many companies already have employee or stakeholder advisory panels in some form, and some have junior boards to engage the next generation. These could be adjusted to meet the requirements for improving employee voice in some cases. In others they could be complementary. Companies should be encouraged to use multiple methods to engage different stakeholder groups. Companies would have flexibility on how to implement an advisory panel, as long as it met the following criteria:

- Mandate to make a public statement on the key issues facing the company each year. This would be published in the Annual Report and on the company's website.
- Formal channels of communication to the board and to present at the AGM.

Other aspects to be considered:

- **Access to information** – the advisory panel would not have access to confidential information unless the board choose to consult it on a specific topic. This would leave the panel free to voice disagreement on key issues. Where it had been consulted on a topic it would be bound by confidentiality until the information was made public. Employees of the company already have access to private information and so a process would be required to ensure that such confidential information was not inadvertently publicised in public statements made by the panel.
- **Communication to the board** – to be effective the panel would need a clear communication channel to the board. This could involve a set amount of time to regularly present to the board, and designating non-executive directors to liaise with the panel. An increasing number of non-executives now take part in reciprocal mentoring programmes which if used effectively could enhance the flow of information and support the forming of relationships between the panel and the board.
- **Resources** – given the panel would be made up of employees it would need some staffed resources to investigate issues in greater depth. This could be further enhanced by the ability to commission third party studies. Or the panel could include some part-time employees who have time to dedicate to the panel's work.
- **Public statements** – to give the advisory panel some degree of power it would write an annual statement with its view on the key issues facing the company, including its view on executive pay. This would be included in the annual report.
- **Involvement in the AGM** – this could be further enhanced by incorporating a presentation by the advisory panel at the AGM and having them available for questioning. This could help make the AGM more lively and relevant. At present it has currently become a rather procedural affair where the large investors do not regularly attend.
- **Union interaction** – 10% of private sector employees are union members, and 16% are covered by collective bargaining. In these companies the structure should be designed so as not to overlap or substitute the work of the union.
- **Next generation** – a number of companies are starting to consider 'shadow boards' or next generation advisory forums. These should be encouraged and recognised as legitimate parts of the company's approach to employee voice.
- **Monitoring and enforcement** – the proposal is that employee advisory panels would be broadly self-enforcing. The first question for an advisory panel would be to comment on how well the company has fulfilled the spirit and the letter of the government's new provisions. This would create an internal dynamic, based on transparency, which would reduce the need for any external inspection. If the panel decided the company had not met the government's guidelines it could publish a statement on the discrepancies.

For subsidiaries of multinational companies

UK subsidiaries of foreign and domestic multinationals would probably choose option 2. An employee advisory panel could be formed for UK operations that would have channels of communication into the UK management board of the company. It could also present annually to the group level board of directors. There would still be the requirement for an annual public statement.

This structure could work for a UK based multinational where the majority of employees are not based in the UK. It would also work for a foreign multinational operating in the UK.

7. Conclusion

There is rising acknowledgement across the business and investor community that some action needs to be taken to open up the boardroom a wider range of influences, thereby improving corporate governance and helping to restore trust in business. The representation of the employee is perhaps the most important, but not the only stakeholder dimension that the government will need to consider. While there is broad support that employee voice needs to be increased within governance structures, there is healthy disagreement on how this is achieved. In keeping with the UK's approach to corporate governance, a flexible approach is likely to be most effective.

Under this companies which are already offering such employee voice in their own way may need take little further action beyond formalising the arrangements by which such forums or panels report their feedback. Companies which do not have any such arrangements will be prompted to think imaginatively about the route to strengthening employee voice that suits them best.

The policy in this area needs to be part of a wider strategy by government to encourage long term wealth creation by companies, and to liberate businesses to find their own way to rebuild trust while remaining agile and entrepreneurial.

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About Tomorrow's Company

Tomorrow's Company is an independent non-profit think tank that exists to inspire and enable companies to be a force for good. It believes business can create more value for shareholders and society by adopting an approach that focuses on purpose, values, relationships and the long term. It succeeds in its goal by convening business leaders, investors, policymakers and NGOs to develop practical solutions. Tomorrow's Company was founded in 1995 following the RSA inquiry into the role of business in a changing world.

About the Good Governance Forum

The Good Governance Forum was formed in March 2010 in response to questions raised about the effectiveness of corporate governance as a result of the financial crisis and the subsequent reviews by Sir David Walker and the FRC. It brings together a number of key businesses, organisations and individuals to explore what good governance means, and to make practical recommendations to company boards and policy makers.

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