



# Worker Representation on Remuneration Committees

Why do we need it and how would it work in practice?

## Worker representation on remuneration committees

### **This briefing:**

- Sets out why the proposals recently set out by the Business Secretary are not sufficient to put the brakes on executive pay.
- Presents clear academic evidence that high wage disparities within companies harm productivity and company performance.
- Shows why worker representation on remuneration committees is needed and how it already works in other countries.
- Shows that worker representation on remuneration committees is associated with lower rates of CEO pay.
- Shows that the so called 'risks' and practical objections to this measure have been significantly overstated;
- Concludes that there are no legal barriers to enabling worker representation on remuneration committees.

### **Shareholder oversight of executive pay has not worked**

Since the Greenbury Committee published its report on executive pay in 1995, the public policy approach to addressing executive pay has been increased disclosure requirements for companies combined with giving shareholders powers to act over executive pay.

Since 2003, shareholders have had an advisory vote on remuneration reports at company AGMs. Yet since then, only 18 remuneration reports have actually been defeated.

There are a number of reasons why relying on shareholders to tackle executive pay is unlikely to work:

- Fund managers – and it is fund managers who actually cast the majority of UK shareholder votes on behalf of the ultimate beneficiaries - are themselves very well paid and many see nothing wrong in company directors receiving rewards that to the general public are perceived as excessive.
- Shareholders are often reluctant to vote against remuneration reports even where they have do concerns, seeing a public vote against as being somehow 'confrontational' and preferring to work behind the scenes to exert pressure. While raising the threshold required to pass remuneration reports to 75% should make it easier to defeat remuneration reports, it is not clear how this and making the vote binding will affect voting behaviour. Some fund managers have indicated that a binding vote will make them even more unlikely to vote against remuneration reports.
- Even where UK institutional investors do take a strong stand on a remuneration report, over 40% of UK-listed shares are now held by overseas investors, which makes it harder to influence executive pay through generating a national debate and consensus on the issue.

Shareholders have had their opportunity to put the brakes on executive pay and have failed to do so. It is time for a new approach.

### **Gap between pay of directors and ordinary workers has continued to rise**

The gap between the pay of company directors and the rest of the workforce has continued to rise: the High Pay Commission found that in 2010 the average FTSE 100 CEO total pay was 145 times the average salary for UK workers. Addressing this growing gap is important for companies and for the wider economy.

There is clear evidence that a high wage gap between top earners and ordinary workers within companies is damaging to company performance. For example:

- A study of 4,735 companies between 1991 and 2000 found that within-firm pay inequality is significantly associated with lower firm performance<sup>1</sup>.
- A second study that used compensation data from Standards and Poor's ExecuComp (covering around 1,500 companies per year) found that firm productivity is negatively correlated with pay disparity between top executive and lower level employees<sup>2</sup>.
- A third study of over 100 companies found that low pay differentials were associated with higher product quality<sup>3</sup>.

The clear and negative impact of high pay differentials on company performance shows that this is an issue that shareholders and Government should take extremely seriously, and makes a strong case for the inclusion of worker representatives on remuneration committees.

### **Remuneration committees are already required to take employee pay and conditions into account**

Remuneration committees are already required to take into account pay and conditions elsewhere in the company when setting executive pay and to report on how they have done this in their remuneration reports. However, there is no evidence that consideration of workforce interests has made any difference to decisions on executive pay, even in the present environment in which many companies are laying off workers or giving their workforce a real terms pay cut or

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<sup>1</sup> Pedro Martins, Dispersion in Wage Premiums and Firm Performance, Centre for Globalisation Research Working Paper No. 8 April 2008

<sup>2</sup> Olubunmi Faleye, Ebru Reis, Anand Venkateswaran, The Effect of Executive-Employee Pay Disparity on Labor Productivity, EFMA, Jan 2010

<sup>3</sup> Douglas M. Cowherd and David I. Levine, Product Quality and Pay Equity Between Lower-Level Employees and Top Management: An Investigation of Distributive Justice Theory, Administrative Science Quarterly, Vol. 37, No. 2, Special Issue: Process and Outcome: Perspectives on the Distribution of Rewards in Organizations June 1992

both. Remuneration reports pay lip-service to the issue, with many making a one-line reference, or ignore it entirely.

The Secretary of State proposes to enhance these requirements so that remuneration reports would be required to say how they have consulted employees and how they have taken into account pay differentials within companies. The TUC is very concerned that without significant reform to remuneration committees these provisions will have little impact, and that remuneration committees will continue to pay lip service to the pay and views of the workforce, as they do at present.

### **Worker representatives on remuneration committees**

The TUC strongly supports mandatory worker representation on remuneration committees. We believe that the so called 'risks' and practical objections to this measure have been significantly overstated.

Worker representation on remuneration committees would bring important benefits:

- Workers would bring a fresh perspective and common sense approach to discussions on remuneration, in contrast to the current culture that presides on remuneration committees.
- The Government has acknowledged the importance of taking into account both company pay differentials and consulting with workers about directors' pay. The best way to ensure that these issues are considered properly in decision making is for workers to be represented on remuneration committees.
- Workers' interests are inextricably linked to the long-term success of their company; they are therefore well placed to contribute to discussions on an appropriate remuneration strategy to serve the long-term interests of the company.
- Including workers on remuneration committees would engender a higher degree of buy-in from employees on pay arrangements at their company. This should contribute to employee engagement, which is shown to be linked to higher company productivity and performance.
- Research has shown that worker representation does help to curb directors' remuneration. One study showed that, among the largest 600 European companies, the presence of board level worker representation is correlated with lower CEO pay and a lower probability of stock option plans. A second study showed that, within large German companies, stronger worker representation on the board led to lower CEO pay and less use of stock-based remuneration<sup>4</sup>.
- As noted above, there is clear academic evidence that high wage disparities within companies harm productivity and company performance. Combined with

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<sup>4</sup> Board Level Employee Representation, Executive Remuneration And Firm Performance In Large European Companies, Sigurt Vitols, March 2010; and Arbeitspapier 163, Beteiligung der Arbeitnehmervertreter in Aufsichtsratsausschüssen, Auswirkungen auf Unternehmensperformanz und Vorstandsvergütung, Studie im Auftrag der Hans-Böckler-Stiftung, Sigurt Vitols 2008; both available from the TUC

evidence (cited above) that worker representation on remuneration committees is associated that lower rates of CEO pay, this makes a strong case for the inclusion of worker representatives on remuneration committees.

- If this proposal were implemented, the TUC would work with suitable partners to provide accredited training to worker representatives. We would also organise a network for worker representatives on remuneration committees, as we already do very successfully with trade union member-nominated pension fund trustees. This would help to ensure that worker representatives were able to contribute effectively to remuneration committee discussions.

### **International precedents for worker representation on remuneration committees**

In Germany, worker representation on remuneration committees is common in large companies. By law, in companies with more than 500 employees, one third of supervisory board members must be worker representatives and in companies with more than 2,000 employees, half the supervisory board members must be worker representatives. The courts have ruled that supervisory board committees including remuneration committees in co-determined companies should include at least one worker representative. In practice, in most of the remuneration committees of companies with more than 2,000 employees in Germany, half the members are worker representatives.

### **Would worker representatives on remuneration committees need to become board members?**

The TUC notes that in Continental Europe there are many examples of successful corporate governance models in which worker directors sit on company boards. However, workers would not need to become company directors in order to sit on remuneration committees in the UK. Health and safety committees and CSR committees are among those that provide precedents for important company committees that often include both board and non-board members in the UK.

There is no requirement in company law for companies to establish remuneration committees. The Corporate Governance Code, which applies to listed companies on a comply or explain basis, does stipulate that companies should establish remuneration committees of non-executive directors (see Code Provisions D.2.1. and D.2.2):

“The board should establish a remuneration committee of at least three, or in the case of smaller companies two, independent non-executive directors. In addition the company chairman may also be a member of, but not chair, the committee if he or she was considered independent on appointment as chairman. The remuneration committee should make available its terms of reference, explaining its role and the authority delegated to it by the board... The remuneration committee should have delegated responsibility for setting remuneration for all executive directors and the chairman, including pension rights and any compensation payments. The committee should also recommend and monitor the level and structure of

remuneration for senior management. The definition of ‘senior management’ for this purpose should be determined by the board but should normally include the first layer of management below board level.”

Given that the Corporate Governance Code should be applied on a comply and explain basis, there would be no significant legal obstacle to companies appointing workers to their remuneration committees and simply explaining the reasons for this in their remuneration reports, so long as this was compatible with their Articles of Association. Unless their Articles of Association state that the remuneration committee must comprise board members only, which is unlikely, appointing workers to their remuneration committees is something that companies could start to implement right away, using their remuneration reports to explain why they had taken this action.

### **Public policy change is needed to enable worker representation on remuneration committees**

However, the TUC believes that for worker representation on remuneration committees to become a reality in more than a few isolated examples requires public policy intervention. There are different ways of doing this.

#### *Corporate Governance Code*

The Corporate Governance Code could be amended to require worker representation on remuneration committees. This could be done with a relatively simple insertion to Code Provision D.2.1. as follows: “The board should establish a remuneration committee of at least three, or in the case of smaller companies two, independent non-executive directors and at least two worker representatives.”

#### *Listing Rules and company law*

An alternative way of introducing worker representation on remuneration committees would be through a direct amendment to the listing rules. Alternatively, company law could be used to introduce the requirement, although as company law does not currently require companies to establish remuneration committees, this would require a more substantial reform.

#### *Remuneration committee terms of reference or duties*

Having board and non-board remuneration committee members raises the issue of the duties of remuneration committee members. Both executive and non-executive board members in the UK are bound by directors’ duties as set out in Chapter 2 of the Companies Act 2006. While worker representatives would not be automatically bound by these duties, the TUC believes that terms of reference or duties for committee members could be established based on the existing directors’ duties. The TUC believes that worker representatives could play a valuable and constructive role on remuneration committees while complying fully with the central requirements of directors’ duties as set out in Chapter 2 of the Companies Act.

## **Worker representation will not lead to confidentiality breaches**

It is a well-established principle within industrial relations that at times union representatives may be given access to confidential company information in order to enable them to represent the interests of their members in discussions and decision-making. Union representatives are well used to maintaining confidentiality in relation to sensitive information that may be given to them by management. There are also numerous examples of union representation on public bodies whose discussions are subject to confidentiality requirements, including the Low Pay Commission and the Court of the Bank of England. In countries with worker representation on company boards, confidentiality requirements which may be set out in law generally apply, and worker representatives (along with other board representatives) are accustomed to operating within these rules.

While public policy is clearly promoting greater transparency in relation to decisions on executive remuneration, remuneration committees may wish to establish confidentiality requirements in relation to some aspects of their discussions. The TUC believes that this is fully compatible with worker representation on remuneration committees, and believes that worker representatives on remuneration committees would be able to fulfil a constructive and useful role within any reasonable agreed confidentiality requirements.

## **How would worker representatives be nominated?**

The TUC proposes that where trade unions are recognised, worker representatives should be nominated through the recognised trade union/s at the company. This would minimise the work required for companies to appoint worker representatives to their remuneration committee and ensure that the worker representatives were chosen through a legitimate and democratic process.

There are important legal precedents for requiring that where union are recognised, consultation should take place with union representatives, including consultation over collective redundancies, consultation on transfers of undertakings (TUPE) and in the Takeover Code (see Annex for more details).

Independent trade union representatives alone have the right to union recognition and can negotiate collective agreements. This is because they are genuinely independent and are deemed in law to have the 'agency' to agree on pay and conditions on behalf of workers. It is absolutely in keeping with this established role that recognised trade unions should be involved in wider discussions about company remuneration including executive pay, and therefore appropriate that nominations to remuneration committees should be made by recognised trade unions where they exist.

Similarly, all employment rights providing for workplace agreements (for example, on reference periods for the 48 hour week under the Working Time Regulations, changes to rules relating to when permanent staff become permanent and negotiations relating to more flexible arrangements for parental leave) require that

where unions are recognised, consultation should take place with union representatives.

Where unions are not recognised, an election should take place in which all UK workers are entitled to stand and to vote. There are many precedents that already exist in UK employment legislation (for example consultation on collective redundancies) for how this should be carried out.

For companies that employ only a small number of workers in the UK but employ significant numbers of workers in other countries, it would be possible to establish a different process for appointment of worker representatives. There are precedents from established processes such as, for example, appointing members of European Works Councils, that could be drawn on for this. However, if a company is listed in the UK and its board is drawn mainly from the UK, it is reasonable to expect it to reflect UK-established procedures for executive remuneration, which is why such a company would be expected to follow the Code of Corporate Governance or explain why it was not doing so. There is no reason why worker representation on remuneration committees should present major practical obstacles for companies, regardless of the location of their workforce.

### **Although not *necessary* to enable representation on remuneration committees, worker directors have potential to add value**

While it is not *necessary* for workers to become company directors in order to serve on remuneration committees, strong support for workers becoming company directors has been expressed by the Secretary of State and others. The TUC believes that workers would bring a valuable perspective to company boards and is planning to publish a report on potential reform in this area in due course.

There is nothing in UK law that says that company workers cannot be members of the board. Indeed, it is absolutely normal for the Executive Director or CEO of the company and other senior executive directors to be members of the board. Legally, there is no distinction between the Executive Director and an ordinary worker becoming a board member.

Although rare, ordinary employee directors do exist in the UK; for example, First Group PLC has a Non-Executive Employee Director who is currently serving his third term as Employee Director and was appointed to the Board as Employee Director in January 2003.

However, a key distinction between worker representatives on supervisory boards in Germany and the situation of the Employee Director of First Group noted above is that the latter, along with all other board members, both executive and non-executive, was elected by shareholders at the company's AGM. Worker representatives on the supervisory boards or remuneration committees of German companies are not generally elected by shareholders but are nominated by workers and trade unions.

UK company law does not specifically require that directors should be elected at company AGMs. The Corporate Governance Code does, however, include a requirement for FTSE 350 directors to be elected at AGMs, now on an annual basis. It is also set out in many quoted companies' Articles of Association that directors can be appointed by the board but are also subject to election at company AGMs.

While not necessary for establishing worker representatives on remuneration committees, the Secretary of State has spoken in favour of greater worker representation on UK boards. There are different options for addressing the legal issues that this poses for appropriate nomination processes.

- One option would be to amend company law to include a specific category of worker director that would be nominated by workers and their representatives. This could be accompanied by a consequent amendment to the Corporate Governance Code to exclude worker directors from the requirement to be elected by shareholders at AGMs.
- Alternatively, worker directors could be nominated by unions or elected by workers where unions are not recognised, but also be subjected to election at company AGMs along with other directors. This would require no amendment to company law or the Corporate Governance Code.
- It would be very important that worker representatives on company boards in the UK were chosen by workers and their representatives, not by shareholders who already hold considerable rights in relation to electing company board members and corporate governance more broadly. For this reason, the TUC would have concerns about a system where workers who were nominated by unions or elected by company workers were subject to an additional election process at company AGMs.
- The TUC plans to undertake additional work around these issues and to publish a report on possible reforms to the UK corporate governance system later in the year.

## Annex

- Collective redundancies - requirement to consult

Where a union is recognised for employees affected by collective redundancies, consultation must take place with the union. Only if there is no union can workplace representatives be consulted (Trade Union and Labour Relations (Consolidation) Act 1992 section 188 (1B))

<http://www.legislation.gov.uk/ukpga/1992/52/section/188>

- Transfer of Undertakings (TUPE) - requirement to consult

Where a union is recognised for affected employees, then consultation on transfers of undertakings must take place with the union. Only if there is no union can workplace representatives be consulted (TUPE Regulations 2003 Regulation 13(3))

<http://www.legislation.gov.uk/uksi/2006/246/regulation/13/made>

- Takeover Code

Employees and their representatives have rights to information at key stages in a mergers or takeover. The rights to information apply to 'employee representatives or, where there are no employee representatives, to the employees themselves'. Employee representatives have the right for their opinion of the bid to be circulated at the company's expense to shareholders. This right applies only to employee representatives, and does not apply to employees if there are no employee representatives. The Takeover Code which governs this process has recently been amended, and includes a new definition of an employee representative. The Takeover Code defines an employee representative as:

- a) a representative of an independent trade union, where that trade union has been recognised by the offeror or the offeree company in respect of some or all of its employees; and
- b) any other person who has been elected or appointed by employees to represent employees for the purposes of information and consultation.

[http://www.thetakeoverpanel.org.uk/wpcontent/uploads/2009/01/Code\\_190911.pdf](http://www.thetakeoverpanel.org.uk/wpcontent/uploads/2009/01/Code_190911.pdf)