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Committee Secretary
Parliamentary Joint Committee on Corporations and Financial Services
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September 12, 2005

Dear Sir

Submission to inquiry into Corporate Responsibility

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1. Summary:

The recommendations of this submission illustrate how: (a) The interests of shareholders and directors can be protected and furthered while enhancing social and environmental responsibility and (b) The law, regulations, codes, and the cost of compliance can be reduced by introducing into corporate constitutions self-enforcing processes to report on and take into account triple bottom line issues.

This submission recommends that no changes are required in the duties of directors but there is a need for corporate constituents to be given appropriate voice to report on business activities and on the social and environmental impact of operations to shareholders, directors, investors and the general public. Reports by constituents would provide a basis for reducing the scope of information specified in statutory reports by directors while increasing the scope of information provided by the company.

It is not the duties of directors or the scope of their reporting that should be increased but the formal involvement and engagement of corporate constituents on whom all operating companies rely upon for their existence.

Two changes in corporate law are suggested:

(i) Non trivial[1] corporations[2] required to adopt constitutions that allow stakeholders to form advisory councils that represent the various constituencies of the corporation to inform the

[1] The definition of "non-trivial" corporations is considered in the concluding remarks.

directors on business operations and any other matters of concern such as social and environmental issues.

(ii) A contingency power introduced to allow in exceptional circumstances when corrective and/or remedial action is not taken by directors for widespread social or environmental harms created by their company for the directors to be replaced by nominees of stakeholders.

The first change would provide a way to substantially reduce corporate law, other laws, regulations, and regulators by providing self-enforcing processes for corporate stakeholders to protect themselves. Besides reducing the cost of company regulation and compliance it could improve the protection of investors and stakeholders on a much more effective, quicker and flexible tailor made basis to company specific concerns rather than relying on one size fits all rules and regulations.

The possibility of the second change being activated would make directors and shareholders very sensitive to social and environmental impact of their company. It provides a compelling incentive for directors to promptly take corrective and/or medial action for any harms created by their company that attracted wide spread community concerns.

2. No change in director's duties is required but the scope of their reports replaced

No change in director's duties is required as they already have a duty to "the company as whole". This means directors have a duty to any stakeholder on whom any operating company must rely upon for its very existence and so its day to day operations.

As no operating company can exist without workers, customers and suppliers, including the infrastructure services provided by the host community, this means that directors already have a duty to the "strategic" stakeholders who constitute "the company as a whole". The term "strategic" is used because the very existence of an operating company is dependent upon individuals working in the firm or in supplier or customer entities or those that are individual suppliers or customers.

Investors are not considered strategic stakeholders as self-financing companies can exist without them (as shown with management buyouts) and investors can have a much shorter time horizon than individuals who are strategic stakeholders. Because only individuals are defined as strategic stakeholders their participation enriches democracy to support the political "license" for corporations to exist and operate.

Strategic stakeholders are citizens on whom any corporation must depend for its operations. They make up "the company as whole". Taking into account the interest of strategic stakeholders is consistent with the statutory obligations[3] of directors to "exercise their powers and discharge their duties in good faith in the best interests of the corporation; and for a proper purpose."

There is nothing in the law that places a duty on directors to maximize shareholder wealth although this is commonly stated or implied. Corporations may be used for non-profit and charitable purposes. It is

[2] The term corporations is used to include those that are publicly traded, controlled by foreigners, governments or private individuals or are non profit incorporated bodies.

[3] Refer to Corporations Law, Section 181 (1), http://scaletext.law.gov.au/html/pasteact/3/3448/0/PA002380.htm

quite legal for incorporated charities to distribute their wealth to non members. The need for directors to maximize shareholders wealth arises only in the context of the criteria used by shareholders to vote for directors or sell their shares. There thus appears no legal conflict for directors to consider the concerns of citizens who are strategic stakeholders. What strategic stakeholders require is a formal mechanism for them to be given a voice to inform directors of their concerns so these can be taken into account with such views that may be held by the shareholders who have the power to appoint, remunerate and dismiss directors.

In some corporations there are non strategic stakeholders who may be affected by the operations of the company as in the case of asbestos or tobacco victims. It is the strategic stakeholders with their long term interest to protect the reputation of the firm and its brands that can best represent non-strategic stakeholders. In practice, a number of strategic stakeholders could also be individuals affected by contact with asbestos or tobacco to create grass roots community pressure for the company to take corrective and/or remedial actions.

Some corporations might not have sufficient citizens as strategic stakeholders to influence directors to take corrective action. Only in such exceptional circumstances should governments become involved in regulating corporations. However, such regulation should be indirect based on only political action without the need for the intervention of any government bureaucracy or regulator.

To achieve this result the Corporations Law could be amended to allow the Minister to sign an order to retire directors and appoint nominees of stakeholders to allow the company to undertake the necessary corrective action. The threat of this provision being invoked would make directors and shareholders very sensitive to the requirements of their stakeholders without any need to change the duties of directors.

The question arises if this reserve power should be triggered only on political consideration of community concerns and/or on operational concerns of the cost and benefits to the community. A Ministerial discretion based on approaches from concerned stakeholders is one approach. The other would be concerned stakeholders seeking a court order based on a judgment of the cost and benefits of having new directors appointed. Either approach might be suitable or they could be combined. However, the Minister with such reserve powers should be the one most concerned with promoting corporations and investment rather than a Minister in charge of social or environmental matters.

To initiate corrective and/or remedial action operating companies need a “loyal opposition” to the hegemony of information and centralised power of the command and control hierarchies in typical modern corporations. For this reason, this submission argues that it not directors who should be required to provide additional information on the social and environmental impact of the company, but its shareholders and strategic stakeholders.

Indeed, the scope of information which directors are required to report is already excessive. Existing statutory duties of directors to report could and should be reduced by the establishment of formal arrangements for other corporate constituents, including shareholders to take over responsibility to monitor and report on matters that are of concern to them. In this way the amount of information reported would be greatly reduced as only information that was contentious would need to be raised and its distribution could be limited to those who had the will and power to act to make corrective

action. Competitive commercial intelligence could in this way be kept confidential while still being used to initiate corrective action.

At present the law requires directors to report on many things just to cover the contingency that some may be contentious. Remuneration, related party transactions and corporate governance practices are examples. In most cases the information does not reveal contentious matters but this approach means that much more information is distributed than is required. This is costly and becomes distracting to recipients who are overloaded with unnecessary information as it indicated by shareholders who request companies not to send them their full annual reports. Reporting and compliance requirements also take up the time of directors and distract them from their fundamental role to direct and monitor management.

If representatives of shareholders and strategic stakeholders became responsible for reporting then all routine non contentious information could be kept private. This would substantially reduce the volume and cost of information that had to be reported publicly. It would result in exception reporting when a matter was contentious. The various advisory or watchdog boards would decide when disclosure was necessary.

To introduce regulation of corporations by its shareholders and strategic stakeholders corporate constitutions need to give appropriate voice to these constituencies. In this way corporate governance would be replaced by shareholder governance that was influenced by the concerns of its strategic stakeholders on who corporations are dependent for their existence.

How corporations are governed is defined by their constitutions. The reason why company law, regulation and government regulators have grown so large and complex is because corporate constitutions have not kept up with the requirements of investors and the community. Corporate constitutions should be designed to carry out the role of DNA that contains instructions for making all living things self-regulating in complex un-predictable environments on a competitive sustainable basis. Corporate law should follow this approach so as to minimize size, complexity and cost of company law and government regulators.

The science of governance explains the strategy found in nature for making living things self-governing and why self-regulation does not work in the way corporations are currently constituted. The approach recommended in this submission is based on the science of governance. However, the full potential of this approach is not the subject of this submission that is restricted to triple bottom line concerns. But some of the broader potential is indicated in the next Section.

3. Why changes in corporate reporting are required

A fundamental reason for a company to appoint directors is for them to monitor management and direct their activities. However, corporations typically have no systemic processes for Non-Executive Directors (NEDs) to carryout their fiduciary duties in this regards that is independent of the management that they monitor and direct. This is irresponsible. It defeats a fundamental reason for NEDs to be appointed to a board.

It is very much in the interest of shareholders and prospective investors that corporations establish systemic processes for NEDs to obtain the information independently of management to monitor and

direct management and the company with due diligence and vigilance. For this reason, it is in the interest of shareholders to approve changes in corporate constitutions to provide the NEDs with processes for being informed independently of management on the Strengths, Weaknesses, Opportunities and Threats (SWOT) of both management and the business.

The most informed, expert and self-interested sources of information about the SWOT of management and the business resides with employees, customers, suppliers including services provided by the host communities. Each of these constituencies needs to have a process to inform management, NEDs and when appropriate shareholders and the wider community on the SWOT of management and the business. To achieve this objective and legitimate the role of NEDs, corporate constitutions need to provide a basis for each class of strategic stakeholder to nominate and elect its own advisory council. Stakeholder councils could provide "loyal opposition" to the views of management for NEDs to consider. In most contentious situations there can be more than one side to a story and NEDs need to become aware of these to responsibly select the most appropriate course of action.

Because no operating business can exist without its strategic stakeholders it also makes excellent sense for management to obtain feedback and feed forward information from the constituents of the firm. In this way they can obtain an early warning system on any problems or matters of contention and minimize and contain unpleasant surprises before issues are reported to the NEDs.

The involvement of employees, customers, suppliers and members of the host community in the governance of US corporations was recommended by Harvard Professor Michael Porter to make them more competitive in his 1992 report[4]. However, the involvement of such stakeholders should not be through the main board but through advisory boards. In this way the conflicts of interests inherent in any stakeholder involvement can be used to provide a conflicting viewpoint without also those being conflicted becoming involved in managing the conflicts. NEDs alone would manage any conflicts as part of their role to direct and monitor the business.

A legal requirement for non-trivial corporations to facilitate a process for constituents of a company to form advisory boards would provide a basis for reducing the scope of information that the law requires directors to report as the onus could be transferred to various councils or boards. It is the Stakeholder Councils, not the directors that should be required to present in corporate annual reports of non-trivial corporations the social and environmental impact of the business. It is the Stakeholder Councils that should appoint and control any social or environmental auditor along the lines outlined in my 1995 paper on "The Need for Stakeholder Councils in Social Audits" archived at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=55769 Details of the competitive advantages of introducing various stakeholder advisory boards and watchdog boards are presented in a number of my articles[5] archived in the Social Science Research Network library that are linked to my summary page at http://ssrn.com/author=26239

[4] Porter, M.E. 1992, *Capital choices: Changing the way America invests in industry*, A research report presented to the Council on Competitiveness and co-sponsored by The Harvard Business School, Boston.

[5] For example refer to "Stakeholder Cooperation" http://papers.ssrn.com/sol3/papers.cfm?abstract_id=26238 ; "Corporate Governance Reform: Improving competitiveness and self-regulation" http://papers.ssrn.com/sol3/papers.cfm?abstract_id=41383 ; "Competitiveness and Self-regulation" http://papers.ssrn.com/sol3/papers.cfm?abstract_id=45321 ; "The Competitive advantages of compound boards" http://papers.ssrn.com/sol3/papers.cfm?abstract_id=277537

The need for a shareholder committee for publicly traded corporations is reinforced by the introduction of stakeholder councils so as to provide an authority independent of the directors but *with the interest of shareholders* to review the content of stakeholder reports to shareholders and so the public. The main role of a shareholder committee would be to manage director conflicts of interest such as those that arise from controlling the financial or any social or environmental auditors that may be appointed; the processes of how directors become accountable, remunerated, appointed and manage any other related party interest. However, another role would be to make substantial reductions in the scope of the information that statutory reports would need to be disclosed on these matters.

The need for corporations to build up a respected brand, maintain and build their reputations provides a basis for believing that NEDs would take notice of any adverse impacts that may be reported by stakeholder councils in regards to social and environmental issues. In exceptional cases where corrective action did not take place then governments could introduce exceptional remedies rather than introducing any additional burdens on directors and companies in regards to triple bottom line reporting and compliance.

It is for this reason that it is recommended that the law not be changed to increase director's duties or reporting requirement but instead that the law require non trivial corporations facilitate the establishment of appropriate stakeholder councils and watchdog boards to take over some of the reporting obligations of directors and extent their scope to social and environmental issues.

4. Summary responses to each of the seven parts of the terms of reference

Reference (a)

The extent to which organisational decision-makers have an existing regard for the interests of stakeholders other than shareholders, and the broader community.

Response to (a):

The law allows considerable discretion for decision makers to take regards of the interest of stakeholders and the broader community. No general change in the law is required except to provide directors with sources of information independently of management to monitor and direct management. The introduction of stakeholder councils creates a process for directors to obtain information that management does not possess or does not want to inform directors about including information about stakeholders and the broader community.

Reference (b)

The extent to which organisational decision-makers should have regard for the interests of stakeholders other than shareholders, and the broader community.

Response to (b)

Organisational decision-makers should have regard for the interest of stakeholders other than shareholders because no business can exist without employees, customers and suppliers including those

providing infrastructure services in the host community. It is just good business sense for directors to formally involve and harness the interest of those stakeholders on who the business depends upon for its existence and competitive advantages. This approach also protects directors from being ambushed and/or captured by agenda's established by management. Stakeholder councils provide a basis for directors to convince shareholders and/or a court that they have processes in place to carry out their duty to monitor and direct management with due diligence and vigilance.

Reference (c)

The extent to which the current legal framework governing directors' duties encourages or discourages them from having regard for the interests of stakeholders other than shareholders, and the broader community.

Response to (c)

The ownership and informational architecture of a company is more influential than the law in discouraging directors to take regards of the interests of stakeholders who are not shareholders and the broader community. It is the context in which directors are informed of the interests of the broader community and stakeholders who are not shareholders that requires changes.

Reference (d)

Whether revisions to the legal framework, particularly to the Corporations Act, are required to enable or encourage incorporated entities or directors to have regard for the interests of stakeholders other than shareholders, and the broader community. In considering this matter, the Committee will also have regard to obligations that exist in laws other than the Corporations Act.

Response to (d)

Two changes are recommended for the legal framework of corporations:

(i) A requirement that non-trivial companies establish in their constitutions the facility for constituents, as described in this submission, to appoint a shareholder committee and stakeholder advisory councils to provide directors with information to carry out their duties to monitor and direct management and the business and provide advice on any other matters that are of concern to stakeholders and the broader community.

(ii) The Minister in charge of corporations to obtain the power to replace directors of corporations with nominees of strategic or other stakeholders in exceptional cases where directors are not meeting community expectations on how the company takes corrective and/or remedial action for harms it created.

Reference (e)

Any alternative mechanisms, including voluntary measures that may enhance consideration of stakeholder interests by incorporated entities and/or their directors.

Response to (e)

Changes in corporate constitutions along the lines recommended could be introduced without legislation. Incentives could be introduced to introduce the same result. For example, a tax incentive could be used to persuade shareholders to adopt corporate constitutions that transferred their ownership and control rights to strategic stakeholders as described in my article on "The Case for Introducing Stakeholder Corporations" available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=436400

Reference (f)

The appropriateness of reporting requirements associated with these issues.

Response to (f)

It is not appropriate or desirable to place the responsibility of reporting on social and environmental issues on the directors as this creates a conflict of interest. It places directors in the position of reporting on themselves and this can jeopardize the integrity of any report and so the purpose of having reports.

Reference (g)

Whether regulatory, legislative or other policy approaches in other countries could be adopted or adapted for Australia.

Response to (g)

The approach of other countries is not grounded in the science of governance and so must represent a less effective approach. The reasons other countries have not utilized the lessons of nature refined over billions of years in establishing self-regulating processes is that the extension of the science of governance from biota, machines and devices to organizations was only recently established through my PhD research

The typical response of law makers and regulators is to require greater disclosure from directors. However, while the disclosure of information is a necessary condition it can be an insufficient condition if there are no individuals with the will and power to take action on the information provided. Increasing the burden of director disclosure increases the work load of directors and compliance costs.

In any event, the integrity of information provided by directors may be jeopardized from the conflicts of interest just as they are when directors report on the financial performance of their company. Likewise the introduction of social and environmental auditors controlled by the directors introduces the same conflicts of interest that make financial audits unreliable.

5. Concluding remarks

The recommendation of this submission would introduce what I describe in my other writings as "Network Governance". Network governance also has application to public sector and non profit organizations. The strengths and weaknesses of this approach is outlined in my article "A framework

for evaluating network governance of public assets" that is available from http://papers.ssrn.com/sol3/papers.cfm?abstract_id=786805

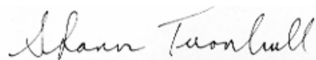
Network governance is explained in my public policy pocket book commissioned by the London based New Economics Foundation in 2002. The full text of the pocket book on "A New Way to Govern: Organisations and society after Enron" can be downloaded from http://papers.ssrn.com/sol3/papers.cfm?abstract_id=319867

The main recommendation in this submission refers to "non-trivial corporations". How these might be defined could be matter of opinion and politics. The social and environmental impact of enterprises might depend upon the annual value of goods or services sold and the number of employees and suppliers. All this information is provided in the records of a company. An appropriate definition of a non-trivial enterprise might be one that had a total of 500 employees and suppliers of record with a turnover of at least $50 million.

However, the nature of the goods and services traded in smaller companies may be a critical factor in the social and environmental impact made so this is a factor that should also be considered in determining the application of any changes. Sample constitutions could be developed for companies and their shareholders to consider and these could be adopted on a voluntary basis for organizations that were not included in the definition of a non-trivial company.

The contents of this submission can be made public and I would be please to provide such follow up information that may be desired.

Yours faithfully



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