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Committee Secretary
Parliamentary Joint Committee on Corporations and Financial Services
Department of the Senate, Parliament House
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September 25, 2005

Dear Sir

Supplementary Submission responding to UK feedback

This is a supplementary submission to share feedback from the UK on the recommendations contained in my initial response dated September 12 submitted under the name of the International Institute for Self-governance as posted on your web page[1]. Also, to comment on the UK proposal to extend the duty of directors as set out in a March 2005 White Paper on Company Law Reform (CLR)[2].

The Chief Executive of the UK Financial Reporting Council (FRC) raised eight penetrating and relevant questions concerning the recommendation in my earlier submission of September 12 that non-trivial corporations facilitate the establishment of separate stakeholder committees or councils elected by various constituencies such as employees and individuals involved as customers and suppliers.

The objective of the recommendation was to reduce the reporting obligations of directors while providing a systematic voice for both improving business operations and alerting directors, but not necessarily the public, on any negative social or environmental impact created by the corporation. While stakeholder reports would increase the scope of company disclosure, the recommendation provides a way to reduce the reporting requirements of directors and also the company to only those matters that were not satisfactorily resolved between the stakeholders and directors.

The reason for this supplementary submission is to put on the public record the eight questions raised by the FRC as they are the type of questions that others might ask. Another reason is that my brief indicative responses set out below to each question provides a basis for better understanding how my recommendation might be put into practice. However, if there was an interest in considering and developing my recommendations I would be pleased to provide a much more detailed response grounded in the literature and in case studies. Public debate would also be required on the matters raised to formulate the most desirable approach.

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[1] http://www.aph.gov.au/Senate/committee/corporations_ctte/corporate_responsibility/submissions/sub16.pdf
[2] http://www.dti.gov.uk/cld/WhitePaper.pdf

The questions were raised in the context of the FRC philosophy of "a well informed market is the best regulator[3]". This leads to the stated first objective of the FRC as an independent regulator to "promote high quality reporting[4]". Such an approach is similar to regulation in Australia that prescribes what is to be disclosed and the standards on which disclosure is to be based. A fundamental problem with this approach under the current corporate reporting architecture is that requires directors to report on themselves! This cannot make sense to ordinary folk who elect our law makers. It shows how law makers have allowed common sense to be overruled by the vested interest of the accounting profession that obtains most of its income from servicing corporate interests.

The intrinsic conflicts of interest, created by the current corporate reporting architecture, explains why it requires excessive and intrusive prescriptive requirements that are costly for companies to comply, regulators to monitor and for professional bodies to determine standards, some of which are not always appropriate. It also explains why so much disclosure has been ineffective.

I am recommending a quite different reporting architecture so that there are fully informed people with vested interests to hold directors to account and decide the nature and extent of corporate disclosure to the public.

The current approach results in more information being disclosed than can be usefully used. While "sunlight" can be the best disinfectant it is little use requiring disclosure of information if there are not people with both the will and the ability to use it to create corrective action. Much information is now required to be disclosed as a contingency measure in case it might be contentious. Shareholder committees provide a way or reducing the current public disclosure requirement by directors to only those matters which the committee considers contentious. Stakeholder councils provide a way of decreasing the scope of information reported by directors while decreasing the amount of information reported publicly to that which was of specific concern. In this way the volume of information reported would be substantially reduced to a need to know basis on contentious issues of concern to either shareholders and/or stakeholders.

A much more important reason for transferring reporting responsibility from directors to shareholder committees and stakeholder councils is that the integrity of the information reported is determined by who is doing the reporting. The Law Lords in the Caparo judgment concluded that this is why statutory auditors are appointed to check the reports of directors[5] not management. However, Auditors who are controlled by directors have failed to identify problems in a number of cases. This supports experiments that show that the behavior of people, and so what they report, is determined by their institutional context[6].

[3] http://www.asb.org.uk/about/regulatory.cfm
[4] http://www.asb.org.uk/about/
[5] Discussed in my paper "How US and UK audit practices got muddled to muddle corporate governance principles" available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=608241
[6] How institutional context determines the character of people was shown by "The Milgram Experiment A lesson in depravity, peer pressure, and the power of authority" at http://www.new-life.net/milgram.htm Experiments specifically designed to show how institutional context determines the reporting behaviour of auditors was reported by Bazerman, M.H., Loewenstein, G., and Moore, D.A. (2002), "Why Good Accountants Do Bad Audits", *Harvard Business Review*, Nov. pp 95–98.

One must conclude that the way to change the behavior of people as to what and how they report is to change their institutional context as proposed by my recommendations. Responsibility for deciding what and how much to disclose is provided by those who require disclosure and/or are affected by it rather than the directors responsible for any problems that might need to be disclosed. Reporting standards then become a secondary consideration be they for accounting, social or environmental matters.

The arguments presented above also explain why there should be little confidence in achieving meaningful outcomes from changing the duties of directors as proposed in the UK White Paper of March 2005 on Corporate Law Reform (CLR) without changing the institutional context in which directors operate. The White Paper states[7]:

> The CLR proposed that the basic goal for directors should be the success of the company for the benefit of its members as a whole; but that, to reach this goal, directors would need to take a properly balanced view of the implications of decisions over time and foster effective relationships with employees, customers and suppliers, and in the community more widely. The Government strongly agrees that this approach, which the CLR called "enlightened shareholder value", is most likely to drive long-term company performance and maximise overall competitiveness and wealth and welfare for all.

To implement "enlightened shareholder value" the White Paper put forward a draft clause[8] under the heading "Duty to promote the success of the company for the benefit of its members" as follows:

(3) In fulfilling the duty imposed by this section you must take account (where relevant and so far as reasonably practical) of —
- (a) the likely consequences of any decision in both the long and the short term,
- (b) and need of the company —
  - (i) to have regard to the interest of its employees
  - (ii) to foster its business relationships with suppliers, customers and others
  - (iii) to consider the impact of its operations on the community and the environment, and
  - (iv) to maintain a reputation for high standards of business conduct, and
- (c) the need to act fairly as between members of the company who have different interests.

Instead of changing directors duties along the lines set out above my submission of September 12 proposes no change in their duties but instead change the institutional context in which directors makes decisions by exposing them to close scrutiny by stakeholders who are affected by their decisions.

How the institutional context would be changed by my recommendations is indicated in my responses to the eight questions set out below:

1. Who is responsible for appointing the committees?

The corporate constitution would give the right for stakeholders of record being suppliers, employees and customers, etc. to form advisory councils using processes utilized by Raph Nader to establish Citizen Utility Boards (CUBs). CUBs were established in US to counter the capture of regulators by the management of public publicly traded utility companies.

[7] Supra note 2, page 23.
[8] Supra note 2, page 90

2. Do you believe that employees, suppliers, etc are competent to take on the role?

Compelling evidence of the will and ability of stakeholders to form informed activist groups is provided by various voluntary "users" associations, unions, supplier assemblies, and "action" groups found associated with various companies around the world.

3. Would they be willing to invest the time required to do the job properly?

Evidence of customers paying for representation so as to hold down prices is provided by the formation of CUBs in the US and the formation of "action" groups referred to in the previous question. Evidence is also provided by the proliferation of pro bono work by highly skilled professional to many non profit organizations that act as public interest "watchdogs" on corporate activities.

4. Should they be paid, and, if so, by whom?

There is no need to pay activists or directors of non profit organizations. Unlike non profit organizations, stakeholders have a vested personal interest in furthering their interest with the company involved. They provide a free service to the company to protect and further their own interests like a union. The prime role of stakeholder councils is not to protect the public interest but to provide feedback information to companies on how they might increase the efficiency and quality of their output and to provide feed forward information on product or service innovation, delivery and strategic direction to reduce the need and cost of R&D, market surveys, etc.

5. Who are they reporting to and do they have any liabilities in the event of reporting failures?

The corporate constitution would specify how Stakeholder councils would report to the directors, say at quarterly meetings. This would provide a basis for rich informal constructive feedback and feed forward information to the Non Executive Directors to legitimize their prime role to monitor the SWOT of management and the business and direct management accordingly. In this way many concerns of stakeholders could be resolved confidentially and not need public reporting.

The process by which directors reported on stakeholder issues and stakeholders made public their concerns not dealt with by the directors would need nuanced checks and balances.

On no account should stakeholders have any liability to any regulator for reporting and any public reporting by stakeholders would be subject to veto by a shareholder committee to protect shareholder interests but not necessarily the interests of the directors who would be held responsible. However, if stakeholders thought that the company was not obeying some law and their report was vetoed by the shareholder committee then provision could be made for the matter to be referred to the auditors to investigate and report. It is assumed that the auditors would not be controlled by the directors but by the shareholder committee as proposed last year to the UK government by the NAPF[9].

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[9] National Association of Pension Funds of the UK made a submission in December 2004 to the UK government as reported at http://www.managementconsultancy.co.uk/accountancyage/news/2036592/napf-urges-audit-shake

6. Given the conflicts of interest between these groups and the directors, how could there be assurance that the reports were objective?

It is because directors might prepare self serving financial reports that the law in the UK requires them to be subject to an independent audit. However, because directors control the auditor the purpose of having auditors is often frustrated as is evident by unexpected corporate failures. Assurance of objective financial reports cannot be presently achieved without the auditor being controlled by a shareholder committee. The objectivity of stakeholder concerns does not become an issue as their ability to report publicly would be subject to the agreement of the shareholder committee or reported for them by the auditor when no agreement was obtained.

7. Do the directors have any rights in relation to the content of the stakeholder reports?

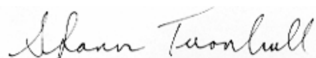
If the shareholder committee allowed stakeholders to report to shareholders and so the public, the directors would have the right of reply. Likewise if the shareholder committee could allow the stakeholders the right of reply to claims by the directors that concerned their interests.

8. How would the stakeholders be relied upon to respect the commercial confidentiality of the information which they examine in order to prepare their reports? Would third parties with whom the company does business be content to rely on the maintenance of confidentiality?

Commercial confidentiality is not an issue if the processes suggested above are employed. This is because stakeholders, other than employees, would not have access to information confidential to management. The opposite situation would most likely occur with stakeholders possessing information that management might not otherwise possess. This is how stakeholders can add value to the enterprise by providing feedback and feed forward information loops. In any event the processes suggested above would not provide a basis for stakeholders to make ANY public reports unless the contents were agreed to by the shareholder committee. As employee councils do not meet with supplier and customer councils there is no formal basis for inside information possessed by employees being shared with customers or suppliers of other firms.

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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