Submission the Inquiry into Corporate Responsibility,

Parliamentary Joint Committee on Corporations and Financial Services

John August

1 Preliminary

In this submission, I will be focusing on items a - e, with some reference to not-for-profit corporations.

I assume the reader is familiar with the term "externality" - when the corporation forces a cost onto some third party. I use the term synonymously with "(ob)noxious behaviour" which I feel better captures the concern.

An externality at the extreme can be a toxic leak from a factory or tailings dump; but it can also be something relatively mundane, like forcing an employee to work overtime who does not want to, and putting pressure on his family life. The cost to the employees' family life is not borne by the firm - it is "externalised".

2 Item a

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

There's an incentive to *appear* to have an interest in the broader community, but this may be in pursuit of better public relations than a desire to genuinely be a "good corporate citizen". To be fair, if a corporation were to genuinely do good, it would be easy to dismiss it as self serving. There is a human tendency to dismiss generosity as being for self interested motives. In any case, it's difficult to tell the difference.

Corporations have significant place in our world; it is important to acknowledge their potential for good. If they are able to deliver services to customers without generating externalities, are supplying a genuine need (as compared to one needing marketing or persuasion), and they do not have monopoly / oligopoly power to manipulate the market, then corporations will do good. A corporation permits activity on a scale which exceeds that which an individual could do.

There is an incentive for a firm to generate externalities - more profit, at least in the short term. If excesses are eventually uncovered, there will be consequences; there is then an interest in behaving responsibly. It may be that the director's interest does not match the shareholder's long term interest (or society's), because the directors obtain their short term bonuses but down the track the firm and society must deal with the consequences of their decisions.

When the directors are obliged to operate in the interest of the shareholders, is this "interest" short or long term ? "Interest"is open to interpretation. Perhaps it would be a good idea to oblige directors to make a statement as to how they will interpret such terms.

If firms have an incentive to generate externalities to pursue profit, there are only three things stopping them - laws & regulations, a fear of being found out, or their own principles.

In one example - BHP at the Ok Tedi Copper mine - we are talking about a location hidden from view. Whether it can be seen, whether it can be found out - is important. Where can corporations hide ? While there have been some discoveries, we can only speculate about hidden noxious behaviour which was *never* uncovered.

2.1 International Dimension

Being "overseas" contributes to being "hidden", particularly when the environmental and other laws are lax in the target country. This might be addressed by insisting that overseas development undergo a "shadow" environmental process similar to that where the corporation is based.

This contributes to firms locating overseas in an attempt to avoid such constraints. An international framework is needed. There's an issue here that needs to be faced : Are we trying to reduce noxious behaviour by corporations in the world overall, or just *Australian* firms ? If the cost of these laws is relocation, at least we know that *Australian* firms are not involved.

Such defences are reminiscent of the statement :

> If we don't sell armaments to this terrible military despot, someone else will.

The most sensible approach here is a mixed one; we pursue reforms of Australian firms, and at the same time participate in international forums to reduce worldwide obnoxious corporate behaviour. We do not use the fact that firms can relocate as an excuse to avoid corporate regulation reform.

2.2 Arrogance of the Present / Ptolemy's Error

There's a claim that "corporations have been getting better, and we can expect this to continue". This seems to be the "arrogance of the present". Nobody ever seems to say "Its a bit screwed up now, maybe if we're lucky we'll be able to fix it over time." It's related to Ptolemy's error, where he assumed the Earth was the centre of the universe; many people say that either *this* is the most crucial time in history, or we've only just *now* got it *all* sorted out.

The justification above seems to be more assurance based rather than some rigorous empirical position. I'm putting forward a few assurances in this submission; but at least I'm willing to admit it.

2.3 The Market and Competition

A further constraint is the market. It can be expensive to be principled, particularly if competitors are not, or they have other advantages. A firm under financial pressure can compete by improving efficiency, generating externalities - or even by running down internal capital in the short term. The choice depends on which is easiest, the scrutiny the firm is under and the ethics of the decision makers.

Competition with international firms can prompt unethical behaviour, but the promise of competition is that it makes firms efficient. This is possible, but is naively considered a

universal. It's possible for all companies in an industry to share inefficiency in a meta-stable equilibrium with insufficient competition to prompt improvement. Competition is a blunt instrument; but certainly better we have a blunt instrument than none at all. There are industries where we hear stories of endemic inefficiency and waste; a scary thought is just how inefficient those firms would be if there were *no* competition.

2.4 The Potential Good of Corporations ; The Balance

The prominence of corporate excess - eg. BHP, Esmeralda, James Hardie - should be contrasted to the good corporations can do. The problem is to weigh out these competing influences; I'm not aware of any even-handed attempts to do this. Most approaches seem to be collecting anecdotes. But perhaps even one case of a corporation "gone troppo" is too many ?

There are two important quantities : the first is the *impact* of firms which do behave obnoxiously; the second is the *proportion* of firms which behave obnoxiously.

Some say the noxious corporations are "a few bad apples". However, even if this were the case, it would not be an excuse for complacency. The bad apples would still be worth finding; it would be important to acknowledge that there are good apples too (Yes, there's the benefit of identifying noxious corporations compared to the burden on principled firms; but I see this as a necessary cost; in any case, when we are dealing with public interest the burden of proof should be on those who might oppose the idea.)

The *proportion* determines whether we can say "corporations are mostly good" (or otherwise); the *absolute* impact prompts us to take action. We should not confuse broad statements about whether "the economy based around corporations is a good system" with the issue of whether to reform regulation.

3 Item b

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

If problems have resulted from a lack of regard for broader interests, we need to expand the regard.

In January 2005, Stephen Matthews, Chairman of the Australian Shareholders Association, stated that directors "have no mandate to make corporate donations in response to the Boxing Day tsunami." Even if directors can make such donations upon detailed examination of the law, it makes sense to have a clear statement so such public tensions cannot arise.

The Chairperson of James Hardie, Meredith Hellicar, has said there is a fundamental conflict between the duties to increase the wealth of shareholders, and broader ethical interests.

Certainly, the testimony from actors in the field suggests problems with current framework; or at least, the possibility of using the current framework to evade ethical considerations.

4 Item 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.

ASIC guidelines mention "acting in the company's best interests". They also talk about using information in a way that harms the company being a crime. They also mention the need to be "honest and careful".

Nowhere do they explicitly mention the need to have regard for the interest of stakeholders other than shareholders. Harming the company may be a crime; this raises questions about the information relating to public impact being harmful to the company if pursued; there's also the question of what happens if there is a choice between something that harms the community and something that harms the company.

Perhaps the detail of the legislation sheds light on this issue, but it does not look promising. Being "honest and careful" covers a little of the ground, but not much. There's presumably an underlying principle of behaviour in accordance with law. But something which harms the community may not be against the law.

This last point is elaborated on by Meredith Hellicar, who talks about "structural irresponsibility". So long as something is not against the law in a technical sense, it does not matter if it is - in an ethical sense - the wrong thing to do. It seem that firms have a habit of refusing to acknowledge unethical behaviour with the excuse of "well, we're doing nothing *illegal*".

If a firm operates overseas in a jurisdiction which does not have an EIS process comparable to Australia's, and does things which they would not get away with in Australia, this provides an important example of how something can be both *legal* and *harmful*. (A broader issue is whether we might consider that we in Australia can "afford" environmental standards that other countries cannot; well, the whole point of being ethical is to set a standard even when the legal situation does not force you to.)

Actions by Australian firms overseas are significant because they can be "hidden" from the view of Australians. In contrast, there are domestic operations. One issue is whether the Australian environmental legislation is as effective as it should be, and whether Australian firms are able to get away with what they should not. But this is a separate issue which I do not plan to review.

Focusing on operations by Australian firms in Australia, we now consider how things might be both *legal* but also have damaging *social* or *environmental* impacts.

The laws of torts and damages do not state on a case-by-case basis whether something is legal or not, as a regulatory framework might do. Rather, it provides for consequences should an action be found out to have an adverse impact later on.

Directors will therefore "take a risk", and in this context they may not be vigorous in seeking out problems with the decisions they make. They may look carefully at the "profitability" risk, but less at the "risk of adverse impacts". There's the sentiment of "accidentally on purpose". Corporations need a conservatism that the public interest would prompt, rather than a purely corporate profit based risk assessment.

The business environment, then, can prompt directors to take risks which are not in the public interest. And, because of the ambiguity of real life, these decisions *will not be illegal* at the moment they are made. We can only hope for a maturity in risk assessment of the directors; but past experience is no reason for optimism.

Decisions involving the public interest are too important to be left to whim of directors

A further complication is that shareholders have limited liability, and that firms can have insurance policies to buffer them from the effects of their decisions. In insurance speak, insurance policies provide a "moral hazard" where people are willing to do things they would not have otherwise done *because* of the insurance policy. These elements have a bearing, but I'm not going to review them in any detail.

The guidelines ASIC provides focus on conflicts of interests between the directors personally and the company. It does not seem to at all engage with conflicts of interest between the company and broader community interests - something that Ms. Hellicar has underlined.

5 Item 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.

When corporations have been obnoxious, have the laws outside the Corporations Act prevented them ? The issue is not that there are penalties for wrongdoing - if people have done wrong things, society has *already* lost. The issue is to stop the things from happening, regardless of existing penalties elsewhere.

6 Item e

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

Voluntary measures have many problems. By themselves, they can be used by firms for obfuscation. There needs to be transparency of company operations and a sufficiently educated, motivated and aware public. Otherwise, voluntary mechanisms can be used to whitewash problems.

If measures are voluntary, there need to be enforcement and transparency conditions, so that it is impossible for a firm to claim it holds to a given voluntary measure without making its processes and claim completely open and independently verifiable. It must be "all or nothing". Adherence to a voluntary code without such provisions is not much better than just asking corporations *nicely* to behave themselves; if they did this naturally, corporate responsibility would not be an issue in the first place.

Picciotto and Mayne comment in "International Human Rights in Context: Law, Politics, Morals" that "to date the great majority of corporate codes have been little more than public relations exercises - fig leaves for exploitation - the latest in a long title of efforts by firms to escape responsibility for the production condition from which they profit."

I understand that Esmeralda and BHP were both signatories to the Mineral Industries Code of Conduct.

The situation suggests problems with voluntary codes; there is too little public awareness to take advantage of them.

7 Extra Issue - Not-for-Profits

> In inquiring into these matters, the Committee will consider both for profit and not-for-profit incorporated entities under the Corporations Act.

For-profit corporations would have larger conflicts of interest with community interests, but there are possibilities for problems with not-for-profit entities.

First, if the stated aim of the not-for-profit corporation is at odds with other segments of society, wasteful tensions may arise. Also, the not-for-profit may be too successful, directing disproportionate resources to the problem compared to the many other problems in the world.

Second, it may spend disproportionate resources on internal administration and little on the problem. This is a danger with for-profit corporations, but here competition will have a moderating effect (but note my earlier comments that competition is not a panacea)

This could be seen as decisions being made in the interests of individuals within the corporation rather than in "the corporation's interest"; but clearly, the community at large would prefer to see not-for-profit corporations efficiently pursuing their stated purpose; its their part of the bargain in having the privilege of incorporation.

While the community at large may have an interest in this, criticism of not-for-profit corporations is usually done by vested interests rather than someone making an attempt to speak on behalf of the broader community's interest in efficiency.

8 Conclusion

I feel there is justification for reform of the corporate regulations relating director's decisions to social and environmental impacts; if voluntary codes are to be used, their problems should kept in mind.