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Committee Secretary
Parliamentary Joint Committee on Corporations and Financial Services
Department of the Senate
PO Box 6100, Parliament House
Canberra ACT 2600
Australia

Inquiry into shareholder engagement and participation

September 29th, 2007

Dear Sir

I submit that there is need for legislative and regulatory change to improve the competitiveness, accountability and sustainability of corporations while reducing the regulatory burden under which they operate by empowering shareholders and other stakeholders to take over regulatory functions.

This decentralised co-regulatory approach would augment and complement the current centralised top down regulatory regime as outlined in my written response to the "Streamlining Regulation Project" of the Australian Treasury. My submission of February 14th 2007 is available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=979531.

The Treasury submission to your committee refers to both the OECD and ASX Corporate Governance Principles which accept and perpetuate the current inadequate powers of shareholders to act as meaningful co-regulators. My critique of the ASX Principles was included in my submission to Treasury referred to above and my critique of the OECD Principles has been published by the OECD and also in England, India and Australia[1].

While both the OECD and the ASX refer to "good" and "higher standards" of governance neither document provides a definition or basis for measurement to provide criteria for determining standards. This demonstrates the lack of rigor and critical analysis about the subject that is perpetuated by official advisors. A fundamental problem is that Corporate Governance is described in terms of Principles or Practices rather than Outcomes as I recommended to the ASX in my submission to them of December 30th, 2006 included in my submission to Treasury.

[1]Critique of OECD revised draft Corporate Governance Principles, January 2004, available at http://www.henrythornton.com/article.asp?article_id=2459. Critique of OECD Principles of Corporate Governance, February 17, 2004, http://www.oecd.org/dataoecd/38/22/27211386.pdf. 'Failure of OECD Governance Principles', *Board Report*, The Journal of the Corporate Directors' Association of Australia ,Canberra, Number 902, p.5, March, 2004; republished in *Corporate Governance International*, England, pp. 10–12, Issue, 125, March, 2004 and by *Chartered Financial Analyst,* The Institute of Chartered Financial Analysts, Hyderabad, 10:5, pp. 34–35, May 2004.

Shareholder regulation of corporations has been frustrated because corporate constitutions provide directors with untenable conflicts of interests by providing them with inappropriate and excessive powers. This has required counter measures to be introduced that have increased the complexity of corporation law, regulations, Regulators, listing rules and the need for corporate governance codes.

The experience of the writer in these matters began in 1967 as a member of private equity group, Tjuringa Securities Limited, which acquired a dozen Publicly Traded Companies (PTCs) over the following seven years. The writer has also been a serial entrepreneur setting up new enterprises three of which became PTCs. I have frequently been involved as a retail shareholder activist including 14 years from 1972 to 1984 as a director of the Australian Shareholders Association.

It is in the interest of government and the efficient and effective operation of its regulators to require that corporate constitutions do not provide directors with inappropriate and excessive powers so shareholders can obtain:

1. The information to act to protect themselves without recourse to the courts or regulators, and
2. The will to take action, with
3. The power to act.

In this way the operations and so size and cost of government regulators could be reduced. It would also reduce the intrusive and costly "one size fits all" laws, regulations and listing rules. Compliance costs to corporations would also be reduced with the need for corporate governance codes eliminated.

Details on how these objectives can be achieved are set out in my presentation in London to staff members of the UK Financial Reporting Council and a representative of the UK Department of Business, Enterprise, Reform and Regulation on September 13th. The presentation was based on my paper 'The Theory and Practice of Government Deregulation' presented to other UK regulators and academics at the University of Cambridge on September 12th. The paper is available at http://papers.ssrn.com/abstract_id=1008453.

This submission will focus on responding to the six points of the terms of reference as set out below:

1. Barriers to the effective engagement of all shareholders in the governance of companies.

Dispersed shareholders are exposed to the problem of collective action. This means that the cost for any one shareholder taking action to protect and further the interest of other shareholders is not fairly shared to provide a "free ride" to others.

The solution is to: (i) reduce the cost of shareholder initiatives and (ii) harness the energy and commitment of individual shareholders who are willing to volunteer their services in an honorary capacity to further the interest of all shareholders.

Both these conditions can be achieved by corporate constitutions allocating governance powers to a shareholder watchdog committee that is provided the information, will and power to act to further and protect the interests of all shareholders as described in my Deregulation paper.

The creation of shareholder watchdog committee for each PTC would facilitate and provide the incentive for shareholders to volunteer their services to become co-regulators. This approach was proposed by Senator Andrew Murray in his 'Minority Report, Company Reform Bill 1997' to the Joint Statutory Committee on Corporations and Financial Services, Australian Parliament, March, 1998, available at http://www.aph.gov.au/senate/committee/corporations_ctte/completed_inquiries/1996-99/companylaw/report/d01.htm.

The volunteer activities of the Australian Shareholders Association illustrate the willingness of individuals to take on these duties as I have done over many years. There are many other non-profit organisations that illustrate the interest and ability of individuals to volunteer their services to look after others. There is much untapped potential to activate the interest of public minded shareholders to act as co-regulators. Many are retired well educated professionals with a wealth of experience, expertise and knowledge with the time to engage as shareholders activist and not be inhibited by opportunity costs to earn a living or make a profit like institutional investors.

2. Whether institutional shareholders are adequately engaged, or able to participate, in the relevant corporate affairs of the companies they invest in;

Institutional shareholders are not and cannot become adequately engaged for the reasons listed below. Just voting at meetings is not adequate. Nominating and voting for members of a shareholder committee provides a way for institutional investors to overcome the reasons why they are not adequately engaged. The reasons arise because:

(i) Institutional investors are minority shareholders and it is costly to engage. Engagement provides a "free ride" to other investors who could be competitors;

(ii) A significant proportion of institutional investors are "index trackers" so there is no incentive to engage as it makes no difference to their relative investment performance;

(iii) It is cheaper and easier for institutions to do the "Wall Street Walk". That is they pass the share parcel to other investors;

(iv) Most institutional investors are themselves controlled by PTCs or rely on obtaining business from PTCs and so do not have the will to act robustly against other PLCs, especially if they share common directors and or interests;

(v) Institutional shareholder engagement requires quite different skill sets to that possessed by investment analysts, investment managers and trustees of pension funds. It requires the most senior and experienced individuals to compelling engage with the directors of PLCs;

(vi) Institutional shareholders generally do not act as Principals but as fiduciaries for other parties and this introduces legal limits on the remit of matters in which they engage. Engagement by Fiduciaries needs to be justified by having economic relevance for their beneficiaries. In this way institutional investors may not be able to engage with corporations in regards to fundamental issues such as the quality of life and democracy and other social and environmental concerns.

For five years from 2001 to 2006 the writer was the Australian Advisor for a leading international institutional shareholder activist owned by Hermes, the pension scheme of British Telecom and the largest pension fund in the UK. A very special feature of the pension scheme was that it was the owner of its management company and so was not beholden to a PLC. This minimised the conflicts of being an institutional shareholder activist.

Another very special feature is that Hermes set up special "Focus Funds" to make shareholder activism a profit centre rather than a cost centre. However, the very special feature of this business model means that it cannot be widely replicated to allow shareholder activism to spread profitably among institutional investors.

The problems in institutional shareholder engagement are considered in greater depth with suggested remedies in my paper 'Invigorating Capitalism', presented to the 6th International Conference on Corporate Governance and Board Leadership, Henley Management College, UK, 6–8 October 2003, http://ssrn.com/abstract=437981.

3. **Best practice in corporate governance mechanisms, including:**
   a. **Pre-selection and nomination of director candidates;**
   b. **Advertising of elections and providing information concerning director candidates, including direct interaction with institutional shareholders;**
   c. **Presentation of ballot papers;**
   d. **Voting arrangements (eg. direct, proxy); and**
   e. **Conduct of Annual General Meetings.**

3a and 3b

There are no agreed "best practices" in regards to 3a with PLCs. There are very few examples of PLC calling for nominees and allowing anybody but the existing board to decide who is nominated. This self-perpetuating process is inconsistent with allowing markets for excellence. It should be terminated. But neither is it desirable that nomination for election be open without a pre-selection process to introduce informed competitive forces for excellence.

An exceptional open example of a PLC calling for nominations and setting up an informed consultative process with its major institutional investors was provided in the US by Lockheed Inc in 1990 as described in my article published in *Board Report*, The Corporate Directors' Association of Australia Limited, 3:2, p.5, March, Sydney, 1998 (Attached an Appendix I).

A useful model to consider for advertising for nominees and appointing them is provided by many government statutory boards and non profit organisations. One model that is worthy of consideration is the twostep "Electoral College" process used by UniSuper to appoint its Trustees. The appointment of officers to a University Senate provides another example but one that does not have a filtering system as carried out by an Electoral College.

There are various other ways that should be considered to introduce competition for excellence in appointing directors. For example, the worker cooperatives based around the town of Mondragon in Spain require at least three persons to be nominated to each board position to create competition between candidates.

When I rewrote the constitution of a progenitor organisation of the Australian Institute of Company Directors I introduced a provision that State Committees did not have the power to select one of their colleagues to be a State President and so a member of the Federal Council unless committee members had been appointed by a contested election. If no contested election was held for the Committee then an election of the State President was carried out by members. In this way every person on the Federal Council became subjected to a contested election. Contested elections are not infrequent in professional organisations that many company directors are members, so this should not be an unusual or unacceptable process for them.

3c, d and 3e

To avoid conflicts of interest, no director should become involved in the presentation of ballot papers, voting arrangements, the conduct of the Annual or other meetings of shareholders or in selecting, engaging, managing and remunerating the auditor. Instead, constitutions of PLCs should reserve these powers exclusively for a shareholder committee as referred to in the above response to point 1 in The Terms of Reference.

No director should chair or control the conduct of a shareholder meeting. No director should be provided open ballots or discretionary voting authority.

The law should mandate cumulative voting for directors to avoid dictatorships of either the majority of minority. Cumulative voting is a form of proportional voting to allow minority interest to appoint directors who can privately inform a shareholder committee when their veto needs to be consider and/or exercised.

Cumulative voting provides the will for directors to act independently of a dominant shareholder and/or a dominant board clique. A shareholder committee provides minority directors the power to act privately without jeopardising their reputation or that of the company and their colleagues who may be considering unfair, unethical or egregious actions. So called "independent" directors in the existing power structure of companies can be made impotent to act to protect the interests of the company as a whole, their own reputations and/or the interests of minority shareholders.

Ideally, all voting should be carried out electronically to minimise the need for proxies and allow all voting to be traced to confirm that:

(i) It is authorised by the ultimate beneficial owners;
(ii) That the votes have not been lent or sold to other parties;
(iii) That multiple voting of the same shares does not occur[2];
(iv) The voting be subject to public scrutiny and
(v) The results be subject to audit,

4. The effectiveness of existing mechanisms for communicating and getting feedback from shareholders;

The existing mechanisms of communications are unsatisfactory as they can be used to perpetuate the hegemony of director and management authority and reduce their accountability. A shareholder committee as referred above is required to carry out the role of shareholder ombudsman and mediator of contested issues.

It is also in the interest of shareholders to obtain reports from stakeholders independently of the directors and their executives on the Strength Weaknesses, Opportunity and Threats of the corporate officers and the business to provide a basis for exercising their votes. This issue is more fully developed to improve the self-regulation of firms to replace government regulation in my paper on 'The Theory and Practice of Government Deregulation' referred to above.

[2] Refer to 'Corporate Voting Charade' at http://www.rgm.com/articles/FalseProxies.pdf by Bob Drummond of Bloomberg. Also: Kahan, M. and Rock, E.G. (2007) 'The Hanging Chads of Corporate Voting' University of Pennsylvania, Institute for Law & Economics Research paper No 07-18, August 13.

5. **The particular needs of shareholders who may have limited knowledge of corporate and financial matters; and**

The ability of uninformed shareholders to participate in corporate governance is met by their ability to appoint members to a shareholder committee. It is impracticable and misuse of resources for every shareholder to invest time to become knowledgeable and become involved in all issues. The delegation of decisions to an informed and committed shareholder committee overcomes this problem.

6. **The need for any legislative or regulatory change.**

Capitalism in its present form is undermining democracy as corporate control is organised on a plutocratic basis of one share one vote. Democracy can be enriched by each PLC having a shareholder committee appointed on democratic basis one vote per investor. Much wider enrichment of democracy can be introduced by corporate constitutions providing their strategic stakeholders with representation on a democratic basis with a voice to further and protect their interests as described in my "Deregulation" paper.

The existing centralised top down approach to corporate regulation and other fields of regulation such as occupational health and safety, equal opportunity, gender discrimination, consumer protection, trade practices, and other social and environmental concerns needs to be complemented with bottom up decentralised co-regulation to improve the efficiency and effectiveness of corporate governance. In this way the size, cost and complexity of government laws and its Regulators can be reduced as a result of good corporate governance that also enriches democracy instead of degrading it.

Concluding remarks

The reasons for my recommendations are explained in my essay attached as Appendix II on 'Why Corporate Governance Reform is failing'.

This submission may be made public and I would welcome the opportunity to provide such further information and explanations that may be desired.

Yours faithfully

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APPENDIX II

Nominating Directors

Published in *Board Report*, Corporate Directors' Association of Australia, 3:2, p.5, March, Sydney, 1998

Directors typically nominate themselves for appointment to company boards. This creates a conflict of self-interest. The Corporations Law states that directors should avoid conflicts of interest.

The same type of conflict would be created if only Parliamentarians were involved in the appointment of an Australian President. Because there were concerns at the constitutional convention that this type of conflict would not be accepted by the Australian electorate, a process for some citizen participation was introduced in the pre-selection of Presidential nominees. Directors could use a similar approach to avoid conflicts in their own nomination.

The argument against allowing anybody to be nominated to the position of President of the country, or a director of a company, is that they may not be qualified for the job even though they may attract the largest number of votes. Being popular may be a necessary condition, but it may not be a sufficient for positions with high public responsibilities that requires specialised knowledge, experience and social skills.

Directors accept the conflict of self-interest in nominating themselves to avoid shareholders forcing inadequately qualified people to be their board colleagues. It can also be used to veto individuals who may raise embarrassing issues and ask questions which may jeopardize board solidarity and/or a comfortable board ambience.

However, the existence of such a "loyal opposition" in the boardroom can avoid a "group think mentality", shared by lemmings, which can lead to disaster. Dissenting views can make board meeting more demanding and so require directors with even greater social skills as discussed in the October 1997 *Board Report*. It can also create innovative middle ground solutions as achieved by the constitutional convention.

The difference between a board meeting, and a meeting of the constitutional convention, was noted by an experienced company director, Sir Arvi Parbo. He was an appointed delegate among a majority of other delegates who were popularly elected. He was reported by *The Australian Financial Review* to remark "The excess of democracy is a little trying".

Some people claim that inadequately qualified individuals, with a high public profile, can get elected to mutual associations like the National Roads and Motorists Association (NRMA) which have one vote per member. Whether of not this occurs, it is a risk which such entities could avoid by establishing in their constitution a process for pre-selecting board nominees.

The question then arises as to who might be best qualified to undertake the pre-selection process? And, how might such a process be enshrined in the corporate constitution to avoid it being by-passed?

The Lockheed Corporation in the US invited 50 of its major institutional shareholders to suggest names and processes to appoint directors in 1990. This was provoked by an active 20% shareholder who sought control. The company obtained 150 names. A request by shareholders to avoid any who had too many other board appointments reduced the list to 80. Only 50 of these names were willing to be considered when advised by a head hunter of the location of the unnamed company. The company removed ten of these because of possible conflicts of interest. The 40 remaining were winnowed to 20 by the head hunter seeking the views of the institutional shareholders. This created nominees acceptable to both the company and institutions from which the company could make a selection.

Another approach used in the US is to appoint a nominating committee made up shareholders instead of the usual practice of using a sub-committee of the board. In some companies, a "relationship" investor carries out this role. Either approach removes the conflicts of interest from the board. The establishment of a committee provides a process which can be embedded in the constitutions, or by-laws of the company. However, dispersed shareholders may not have the inside intimate knowledge of the company to provide a sound basis for matching nominees with the needs of the business.

The very existence, as well as the competitive standing of any business, depends upon its relationships with its strategic stakeholders such as its employees, customers and suppliers. Unlike shareholders, who can walk away from the company by selling their shares, many strategic stakeholders have long term commitments. In addition, they will posses what "independent" directors must by definition lack, that is, business specific inside knowledge and experience. Strategic stakeholders are not only in the best position to advise shareholders, but are by definition, the most vital resource for sustaining the company and its competitive advantages.

It is very much in the self-interest of investors, directors, and management to develop a constructive involvement with their strategic stakeholders. To allow strategic stakeholders to maximise their ability to reduce risks and add value, they need a forum to develop and share knowledge, independently of management. This can be provided through the corporate constitution making provision for stakeholders to appoint their own advisory councils. In this way, shareholders and directors would establish a process for obtaining inside, expert information, independent of management, on the health and competitive standing of the company.

The existence of stakeholder councils to advice directors and investors on the health of the company would in turn provide a strong incentive for executives to nurture constructive relationships with stakeholders to find win-win solutions to problems. Unlike the Lockheed approach, the use of stakeholder councils to advice, or vet, nominees has the advantage that it can be used with corporate entities which have one vote per member or one vote per share. It can also be embedded in the corporate charter or by-laws.

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APPENDIX II

Why Corporate Governance Reform is failing

Shann Turnbull PhD

Corporate Governance reform is failing. Worse, current reforms are heading in the wrong direction. The good news is that these problems can be corrected by applying the laws of nature identified sixty years ago.

The most compelling evidence of failure is provided by the market. Private equity investors can extract more value from Publicly Traded Companies (PTCs) by taking them private. Evidence of failure is also provided by increases in the size and complexity of the law and the budgets of Regulators. The need for Corporate Governance Codes proves that both the law and Regulators have failed. Successful reform would reduce rather than increase the cost of business. The compliance cost the Sarbanes-Oxley (SOX) legislation has resulted in many US companies delisting as this can be done without shareholder approval or other expenses. Foreign companies are avoiding US listings. A leading scholar described SOX as "quack" corporate governance.

Another sign of failure is that law makers, Regulators, Stock Exchanges and practitioners have no agreed definition of what is "good", "higher standard" or "best" corporate governance. Such words are commonly quoted by law makers, Regulators, commentators, and practitioners hustling for consulting business. However, if you cannot define where you want to be, then any road will take you there!

One fundamental problem is that corporate governance is discussed in terms of Principles and Practices that are not subjected to measurement rather than Outcomes that are measurable. It is difficult to manage what is not measured.

As there is no agreed definition of good governance, rating agencies use governance codes as a bench mark of "good" or "best" governance. This creates market forces to lock in current codes and practices. It also creates a circular self-reinforcing but also self-deluding process for defining good governance.

The ASX corporate governance code, like SOX, forces Auditors to be placed in the conflicted position of judging the accounts of the people who engage and pay them! Directors are conflicted by paying those who judge them! Directors are supposed to avoid conflicts.

The requirement to appoint so called "independent" directors is not supported by research that they add value. Scholars have pointed out the lack of clarity of what type of independence is required and what "independence", however defined, is suppose to achieve. This has led one US scholar to refer to the "fetishization" of independence.

Worse still, corporate governance reform has fossilised. It has become a dead end street because corporate laws, regulations, listing rules and guidelines are based on practices rather than outcomes. An outcome based approach would de-fossilize reform by allowing different practices to be developed. Companies could then compete in developing the best practices to achieve the desired outcomes in the most efficient manner[3]. In addition, flexibility would be introduce so one practice would not need to be adopted by all companies.

The outcomes sought would be to protect and further the interest of shareholders and other stakeholders. This should be the purpose of regulations and the mission of regulators and listing rules. Because these failed to prevent major corporate scandals the ASX developed a Corporate Governance Code. This initiative has still increased complexity and compliance costs without a compelling basis to have confidence that scandals will not re-occur.

This leads to the idea that good corporate governance should be defined as reducing the need for laws, regulations, Regulators, listing rules and codes while improving the protection and interests of stakeholders. In other words, "good" governance is achieved by furthering self-governance and "best" governance is self-governance. This definition is consistent with the Science of Governance that is based on the laws of nature. It would also change the role of government from direct intrusive regulation to much more subtle and effective indirect regulation by requiring organisations to adopt self-governing constitutions[4].

The constitution of organisations represents their DNA. No living thing can survive unless self-regulating provisions are embedded in their DNA. Likewise no government should provide a licence for an organisation to exist unless its constitution possessed provisions that facilitate self-governance.

Stock exchanges already specify some elements of corporate constitutions as a listing condition. They could and should do much more. In this way they could eliminate the need for corporate governance codes, simplify corporate law and reduce the size and cost of regulators while providing superior benefits for shareholders and stakeholders. For example, stock exchanges could require corporate constitutions to adopt the investor protection provisions found in shareholder agreements with venture capitalists and include conditions some Bankers use in loan agreements to reduce and/or manage their risk.

The lack of investor protection or the ability of shareholders to further their own interests has been created by corporate constitutions providing excessive and/or inappropriate powers for directors that introduce untenable conflicts of interests. Power tends to corrupt and absolute power tends to corrupt absolutely. Directors possess absolute power as to how they manage their own conflicts of interest. Regulators and Stock Exchange are irresponsible in allowing this situation to be perpetuated.

The solution is to require that power is appropriately shared with those that the law, regulations, Regulators, listing rules and codes are created to protect and further their interests. In this way regulation can be "privatised" and distributed to create a bottom up, custom designed outcome based approach to replace and/or complement the current top down ineffective, intrusive and costly one size fits all approach. However, current reform initiatives are moving in the opposite direction!

The current centralised top down strategy to regulation employed by governments and by a single board of directors to control large organisation can neither be efficient or effective. This is

[3] Specific outcomes are identified in my submission to the ASX of December 28, 2006 included in my response of February 14th, 2007 to the Australian Treasury inquiry into "Rethinking Regulation Project" available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=979531

[4] How either corporations or regulators could initiate better governance is described in my paper 'The Theory and Practice of Government Deregulation' available at http://papers.ssrn.com/abstract_id=1008453.

because the science of governance states that it is impossible to directly amplify regulation/control. Regulation and control can only be amplified indirectly through "supplementation" in the same that it is impossible to directly amplify the signals of radio or TV transmissions. Their very weak signals require supplementation with the energy provided by power mains or a battery.

In social organisations this means that to achieve efficient and effective regulation or control, the energy of co-regulators are required to amplify signals for the Regulator and/or the board of directors. It is in this way that organisations can obtain operating advantages. In particular, firms can also obtain competitive advantages by amending their constitutions to introduce a network of independently constituted in house co-regulators composed of their shareholders and stakeholders.

The impossibility of amplifying control means that Chief Executives require co-regulators to improve the efficiency and effectiveness in the way they control large complex firms. So it is very much in the interests of directors and shareholders that large firms introduce bottom up co-regulators. Co-regulation within firms is required not only to achieve the outcomes sought by corporate regulators but by all the other regulators concerned with such matters as health, occupational safety, gender equality, equal opportunity, consumer protection, trade practices, and other social and environmental concerns.

Co-regulators are also required for CEO's so that they can quickly, accurately and effectively identify and correct inefficiencies and ineffectiveness in achieving desired business outcomes. The natural laws of requisite variety state that the accuracy of communications and control can be improved as much as desired by introducing a requisite variety of independent channels of communication and control. A corollary of this law is that command and control hierarchies lack sufficient variety to reliably communicate or control complexity, let alone achieve regulation in a responsive and sensitive tailor made manner.

The introduction of multiple communication and control channels in firms creates network governance. Firms in rapidly changing complex industries like IT and bio-technology are forced by competitive pressures to adopt network governance. The competitive advantage of network governance in more stable industries has been proven by the nested networks of stakeholder controlled network firms located in Spain. It is through firms providing stakeholders a constitutionally based right to voice their interests that requisite variety in communications can be achieved to reliably control complexity and further their interests.

This is analogous to how the complexity of the human brain is enriched in babies to enhance their intelligence. To simplify the complexity of DNA it does not contain sufficient data to specify how to create all the complex connections for building a brain. Supplementary data is provided from the sensory stimulation obtained from the baby's environment. Network governance likewise supplements the brain of a firm (board of directors) by introducing distributed intelligence with feedback and feed forward information from the business environment.

Network governance is a condition precedent for facilitating self-governance as it introduces a division of power to protect and further the interest of minorities against the interest of dominant shareholders, directors and/or management. One fundamental requirement to facilitate self-governance is for corporate constitutions to separate, management powers that generate value, from governance powers, that can entrench and enrich directors and their associates. Another fundamental requirement is for corporate constitutions to give voice to the various stakeholder constituencies of a firm either directly or indirectly through establishing by-laws. No business can exist without its employees, suppliers, customers, agents, dealers and distributers so it is very much in the interest of shareholders for firms to formally engage and bond with its strategic stakeholders[5].

Research has revealed that stakeholders typically contribute more product innovations than the internal research and development departments of firms. Stakeholders also provide a source of competitive intelligence. The cost of stakeholder engagement can be less than employing market research, human relations and other consultants, but with added advantages.

Crucially for company directors, stakeholders can provide information independently of management on the Strengths, Weaknesses, Opportunities and Threats (SWOT) of their executives and the business. It is very much in the interest of shareholders that their directors have a credible process for carrying out their most fundamental role to direct and monitor management with information independent of management.

It is irresponsible and naïve for directors to only rely on information provided by management. It is naïve because it is not in the interest of management to report problems and deficiencies for which they might be held accountable. If directors do not obtain the other side of the story reported by management then they are being irresponsible not only to themselves but to the company, its shareholders and stakeholders. It is simply not good enough for the fortunes of shareholders and superannuants to be invested in companies where their directors do not have systemic processes for discovering when their trust in management might be misplaced. Nor is it acceptable for the unsecured creditors, especially employees who can have significant unsecured entitlements.

A corporate constitution is like the elephant in the living room that nobody notices. Every company has one but they are not seen. They are commonly accepted as a being given not a variable that needs to be designed to support and further the mission of the organisation. As a result there are no courses to educate business people or their advisors on how to design corporate constitutions[6]. Yet such education could provide competitive advantages for businesses with less risk and reduced director liability for mistakes, deficiencies and/or losses. While political scientists' research and teach how to construct constitutions for countries there is a global knowledge gap on how to design constitutions of firms or other types of organisations so as to sustain and further their operations.

Likewise there is global knowledge gap by social scientists, lawyers, accountants and economists on the existence of the science of governance. As a result, law makers and Regulators do not have the intellectual tools design efficient and effective regulation. While the science of communication and control was only identified in the middle of the last century, it is not "rocket science" although the guidance/steering/governance systems of space craft depend upon it. Sufficient education would be achieved just by reading my PhD Thesis (downloadable from http://ssrn.com/abstract=858244) that describes how the laws of natural science can be applied to social organisations.

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[5] Suggestions on how corporate constitutions could be designed to achieve the two fundamental requirements are described in my article 'Corporate Charters with Competitive Advantages', *St. Johns Law Review*, St. Johns University, New York City, 74:44, pp. 101–159, Winter, 2000, available at http://ssrn.com/abstract=10570.

[6] An exception occurred during 2003/4 when the author presented a course on designing governance systems in the private, public and non-profit sectors as an elective unit of the MBA course at Macquarie University Graduate School of Management, Sydney.

However, until lawmakers and Regulators apply natural laws to regulatory reform, reform will continue to head in the wrong direction. The time is overdue for education in the Science of Governance to be a pre-requisite for all regulators and board advisers.

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