Enhancing organizational performance and social responsibility with self-regulation

Conference working paper

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ABSTRACT

This paper identifies how replaceable rules in corporate constitutions could enhance their operations and social accountability on a self-enforcing basis. The introduction of self-enforcing provisions in organizations creates a strategy for reducing the role and cost of government by exempting complying corporations from the laws made redundant. Self-enforcement is achieved by corporate constitutions sharing powers with those citizens and communities that the government makes laws to protect. To achieve this objective each stakeholder constituency needs to establish separate advisory councils. Each council would advise directors on concerns of their constituencies as well as advice on the strengths, weaknesses, opportunities and threats of management and the business. Only concerns not resolved privately would be publicly reported to reduce the disclosure burden of companies and their directors. While the scope of public disclosure would increase, its volume would be reduced to a need to know basis to those parties that have the ability to take corrective action. To empower dispersed shareholders to protect themselves against dominant management and/or other shareholders, their advisory council would be elected by one vote per investor instead of one vote per share a basis that would also enrich democracy.

JEL Classifications: G38, H11, K22, L20, L50, M14

Key words: Audit committees, Co-regulation, Corporate Governance, Corporate Responsibility, CSR Reporting, Democracy, Self-enforcing regulation, Stakeholder Councils, Watchdog board.

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1. Introduction

The ability of corporations to operate efficiently and add value for investors is under threat from new laws being considered in the UK and Australia to make corporations socially responsible. Unless corporations adopt a self-governing approach, directors and companies are likely to be burdened with additional duties, reporting, and compliance obligations.

The problem of over-regulation has already been exacerbated by a raft of prescriptive and intrusive new laws, regulations and codes introduced as a reaction to the failure of Enron and other major corporations in the US, UK, Australia, Italy and elsewhere. Major compliance cost burdens have been introduced and research is emerging questioning the efficacy of many of the new regulatory initiatives as reported by Clark (2006), Clarke (2006), Linck, Netter and Yang (2006), Ribstein (2005) and Romana (2004). The means for reversing over regulation is for corporations to adopt constitutions that introduce more reliable self-enforcing self-governing processes.

Inherent in a self-governing approach is self-regulation to reduce the size, scope and cost of government, its bureaucracy, laws and regulations. This would introduce a fundamentally different role for government. Instead of direct intervention, governments would act indirectly approving the basis on which organizations could protect and further the interests of their stakeholders and society on a more effective, efficient and creditable basis than can exist with the present reliance on public and private sector organizations designed as command and control hierarchies. The reasons why simple hierarchies cannot reliably be self regulating is presented in Turnbull (1997; 2000).

No longer would governments need to introduce prescriptive laws in the hope that they would be obeyed and then allocating hundreds of millions of dollars on regulators to monitor if compliance with the law was achieved.

An indirect co-regulatory approach is the strategy found in nature to control and sustain living things. Nature uses an indirect approach because it is impossible to directly amplify regulation as proved by Ashby (1968: 265). Ashby describes how regulation can only be amplified indirectly through a process he describes as “supplementation”.

The evidence of evolution and the analysis by Ashby indicates that indirect co-regulatory strategies represents the most effective way of regulating complex activities. In a commercial context it can at the same time reduce the regulatory burden on business. However, an indirect approach has not commonly been used by law makers and in particular in the terms of reference for the “Task force on reducing the regulatory burden on business” announced by the Australian Prime Minister (Howard 2005).

The need for a fundamental change in the architecture of government was noted by the Vice President of the US. Instead of command and control hierarchies of the industrial age Gore (1996a) saw the need for “distributed intelligence” and “distributed control” to answer his question of “How must we update our notions of self-government and bring them into harmony with the Information Age?”

In considering “when government should intervene in the economy” Gore (1996b) suggested “Economic policy perhaps should focus less on ‘priming the pump’ -- and more on ‘imprinting the DNA.” The way to imprint the DNA of social structures is for governments to specify how constitutions of organizations should be designed to promote self-regulation as achieved by living

things. The purpose of this paper is to develop some of the details for introducing this indirect role for government to regulate through "supplementation".

An indirect role for government through co-regulation introduces "A New Way to Govern" (Turnbull 2002a) as it is based on directly involving those parties that governments seek to protect as regulatory agents to protect their own interests. Governments would regulate indirectly by facilitating and empowering citizens to protect and further their own interests instead of relying on the government and the courts. Democracy would be enriched, economic efficiency increased and the dead weight of government reduced.

However, initiatives in 2005 by both the UK and Australian governments to promote Corporate Social Responsibility (CSR) have been based on the traditional approach of introducing additional detailed laws and corporate obligations. This approach is increasing the cost and reducing the efficiency of market economies.

The proposals being considered to make corporations socially responsible in the UK and Australia are outlined in the following Section two. The third Section considers the use of stakeholders in co-regulatory processes to supplement government regulation while the fourth Section identifies how the formal engagement with stakeholders can provide benefits for management, directors, shareholders and the business. The fifth section considers how the role of government would change with an indirect approach to regulation.

2. Current counterproductive proposals in the UK and Australia

In its White Paper (DTI 2005: 90) on Company Law Reform, the UK government proposed that directors' duties be widened to take into account the interests of employees, customers, suppliers, community, the environment and standards of behavior. In an attempt to justify these additional statutory duties and to deflect concern, "double speak" was used to describe it as promoting "Enlightened Shareholder Value" (DTI 2005: 20). But directors accountable to everyone can become accountable to no one. There is already a lack of accountability of directors to shareholders as is illustrated by the excessive remuneration paid to executives.

The threat of more government intervention in Australia has arisen from public outrage over the lack of compensation for victims of asbestos poisoning by a local manufacturer that moved its operations overseas. As a result, the Australian government sort to demonstrate that it was doing something. One initiative was a request in March 2005 for its Corporations and Markets Advisory Committee (CAMAC 2005) to recommend how the law might be changed. Another initiative was a request in September 2005 to the Corporate Governance Council of the Australian Stock Exchange (ASX) to develop standards for sustainability reporting (Buffini 2005). In addition the Australian Parliamentary Joint Committee on Corporations and Financial Services (PJCCFS 2005) initiated a public inquiry into Corporate Responsibility.

The two CSR initiatives by the Australian government provided a way for it to win support from the electorate. However, this would be at the expense of degrading the free enterprise system with more regulation. The proposals are likely to increase operating costs but without any certainty that CSR is achieved. The initiatives of the Australian government illustrates the need for corporations to build a much wider political mandate to support their "license to operate" without additional laws, regulations and codes.

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One way for corporations to build a wider political mandate is to actively and constructively engage with their stakeholders. This makes good operational business sense because no business can exist without customers, employees and suppliers, including those providing infrastructures services in the host community. Stakeholders on who a business depends for its existence are described as "strategic" stakeholders. Shareholders are not strategic stakeholders because businesses do not require them once they become established as illustrated by management buy-outs and mutual organizations. The formal recognition of strategic stakeholders of record in the constitutions of corporations provides a way to directly involve them to look after their own interests without the need to change the duties of directors as proposed in the UK.

The terms of reference given to CAMAC by the Australian government suggested that director's duties should be changed as proposed in the UK. However, such a suggestion represents political "spin" as there is no need to change director's duties. Section 181 of Australian corporate law (Corporation 2001) requires directors to "exercise their powers and discharge their duties: (a) in good faith in the best interests of the corporation; and (b) for a proper purpose". A "proper purpose" could include CSR, running a non profit business or even giving away funds as a charity.

Corporation law in Australia or the UK does not require directors to maximize shareholder value although this is commonly asserted. The need to maximize shareholder value would only become a legal requirement if this was specified by the constitution of the company. The author has not found any such clause in the constitutions of any of the largest 100 Australian companies he has investigated to rate their governance standing (Turnbull 2003).

Even if the law was changed to increase directors' duties as proposed in the UK there is the question as to the extent that this might produce any change in the way corporations were managed. This question must also be asked about the request to the ASX by a former Australian Parliamentary Secretary to the Treasurer who is now the Minister for the Environment (Buffini 2005). The request was that the ASX should consider making corporations provide information on CSR. But what is the use of reporting additional information if: (a) it can be subject to self-serving spin: (b) citizens do not have the interest or will to act upon it and/or (c) citizens that have the interest and will to act do not have the power or capability to act?

Another problem with the approach to the ASX is that this would not involve privately owned companies and units of foreign corporations. It would provide these non affected firms with additional competitive advantages. Additional burdens of 'comply or explain' for listed companies would add to the incentive for them to go private. Alternatively, it could provide the incentive for them to follow the example of hundreds of US companies who have 'gone dark' to avoid the need to comply with the Sarbanes-Oxley (SOX) legislation (SmartPros 2005).

Going dark occurs when a company removes its shares from being listed on a stock exchange. This can be done with little cost or delay as directors do not need to seek the approval of shareholders. It avoids the cost of major shareholders and/or the company buying out minority shareholders. Investors are left without a market for their shares as occurs when a stock exchange suspends a company. In the US going dark removes the need to file quarterly reports. This illustrates how over-regulation can have unintended consequences of reducing investor protection. There was a 30% increase in US public companies going private during the 16 months after the SOX legislation was introduced (Foote 2004).

Publicly traded companies already provide their shareholders with more information than most investors require as shown by many shareholders in Australia that elect not to obtain the full statutory reports issued by companies. Only some of the information the law requires to be disclosed is acted upon by some people for some companies at some times. In other words much statutory disclosure is made on a contingency basis that it might be useful for someone at some times for some companies. The result is that too much information is reported for most companies for most of the time! In other words most companies incur reporting costs that do not produce any benefits in most circumstances for most of the time.

Instead of contingent scattergun disclosure of corporate activities, a rifle shot approach is required, tailored made for each corporation at any particular time and circumstance. This would substantially reduce the amount of information reported by companies but it could also be used to simplify the law and the duties of directors. The result would be less but much more effective law. A win-win-win result for directors, their companies and stakeholders. How this might be achieved on a basis that also reduced the burden on directors to report social matters is considered in the following section.

3. The use of stakeholders to supplement government regulation as co-regulators

This section considers the need to involve stakeholders in the monitoring of corporations and reporting their activities to relieve the need for directors to report and incur the cost of auditing non financial information.

A fundamental reason for governments to introduce laws and regulators is to protect citizens and the public interest. The size and scope of both legislation and regulators can be minimized by providing citizens the power to protect both themselves and the public interest. This is a fundamentally different regulatory strategy to that traditionally adopted by government. It is the strategy developed and tested over billions of years in nature as a way for living things to regulate themselves so that they can develop and flourish on a sustainable reproducible basis in unpredictable complex environments. The laws of nature on which “the science of corporate governance” are based explain why the current strategy of governments cannot work (Turnbull 2002c).

One reason why centralized regulation cannot work is that it is impossible to directly amplify regulation on a reliable basis as proved by Ashby (1968: 265). This means that the top down regulation favored by most governments and regulators is destined to be unreliable. Reliable regulation requires a “requisite variety” (Ashby 1968: 202) of controllers to match the variety of variables to be controlled. The involvement of stakeholders in the regulatory process provides the means to achieve requisite variety of control to improve or obtain reliability.

Reliable regulation would mean that shareholders and the directors they appoint would need to share control of corporations with their stakeholders and this is not likely to be commercially and so politically acceptable. So this paper and the authors response to the PJCCFS (Turnbull 2005a) only proposes that stakeholders be given voice to provide intelligence to management, their directors and shareholders without any power to control management, their directors or shareholders. This compromise will mean that reliable self-regulation of corporations will be incomplete. However, the compromise could be used to illustrate how a number of provisions in company law, regulations and corporate governance codes could be simplified.

The compromise would mean that there would still be a risk of corporations unexpectedly failing. But the risk would be substantially reduced because of the substantial increase in the variety of feedback information to management, their directors and shareholders. The compromise provides a basis for a substantial reduction in the risk that commercial intelligence is lost, not reported, distorted, neglected and/or subjected to undetected self-serving biases of management and/or their directors. The reliance on auditors to check information would also be reduced.

The need for a requisite variety of information channels to cross check for errors in communication was shown by Shannon and Weaver (1949). As a result engineers design into communication systems a variety of independent channels of data to improve the integrity of information as utilized by computer modems. However, this approach is not used by law makers as noted by the former US Vice President. Gore (1996b) stated that "you'll find well over 150 lawyers, but only six scientists, two engineers, and one science teacher among the 535 people in the House and the Senate. As a result, scientific concepts sometimes elude the vast majority of our elected officials." Scientific concepts like the need for requisite variety in information and control also elude businesspeople and their lawyers who draft constitutions for organizations. Constitutions hard wire the communication and control systems of organizations in similar manner as carried out by DNA for biota.

Shareholders, as residual claimants to corporate wealth, are place at most risk from the inadequacies in the design of corporate constitutions. However, it also places the directors, management stakeholders and society at greater risk of corporate failure or other harms. There is a compelling case for governments to require, and for shareholders to insist, that corporate constitutions build in a redundancy of communication and control channels to provide a fail-safe early warning system of corporate harms, problems and/or failure. Such a situation existed in the US during the 19th century when corporations that created harm to their community could have their license to exist withdrawn by citizens or the legislature (Grossman and Adams 1993: 17).

It is also very much in the interest of stakeholders to obtain a voice in corporations to inform and protect their interests and that of wider society. Even without giving stakeholders power to control they can still obtain influence to protect their interests by having a process to inform directors and shareholders independently of management of their concerns for themselves and the business. In this way stakeholders become co-regulators from providing requisite variety of communication channels for directors and shareholders to direct, monitor and control management and its operations including its social and environmental impact.

It also makes good business sense to include strategic stakeholder in the governance architecture of companies. This is because no company can operate without customers, employees and suppliers, including those providing infrastructures services in the host community. The inclusion of strategic stakeholders in the corporate communication architecture means that there can be a much richer exchange of information to protect their interests without the necessity for it to be publicly disclosed. Stakeholders also can provide feedback and feed forward intelligence from constituents of the firm to improve its operations, identify competitive advantages and strategic direction. These are considered in the following Section with the benefits also available to management, directors and shareholders.

4. The use of stakeholders in providing operating advantages

Shareholders, directors and management can also obtain benefits from obtaining independent feedback from stakeholders. 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. NEDs are commonly placed in the position of not having a process for detecting when their trust in the integrity of the information provided by management is misplaced. This could be seen as being irresponsible. It eliminates a fundamental reason for NEDs to be appointed to a board to monitor management.

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 care, diligence and vigilance as required by corporate law. 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. 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 independently of management.

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. But stakeholder councils can also protect management by providing them with an early warning 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 Porter (1992: 16-17) to improve their competitiveness. However, the involvement of such stakeholders should not be through the executive board as proposed by Porter 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 those being conflicted also becoming involved in managing the conflicts. NEDs alone would manage any conflicts as part of their role to direct and monitor the business.

However, some conflicts could involve related party transactions with dominant shareholders. The management of such conflicts is compromised when dominant shareholders have the power to dismiss or prevent the election of NEDs who may wish to disclose and/or vote against unfair related party transactions or on the processes for resolving related party conflicts. Corporate constitutions can provide at least some NEDs with the will to act by requiring directors to be elected through cumulative voting (Bhagat and Brickley 1984) so minority shareholders can obtain board representation independently of any dominant shareholders and/or management.

While providing NEDs the will to act is a necessary condition it is not a sufficient condition to protect minorities if the NEDs do not have the capability to act. A minority of NEDs on a board do not have the power to act to protect their independence and reputation unless they can have independent access to shareholders to gain their support. One way for such access to be provided in an efficient and

effective way is for shareholders to appoint a "watchdog" (Turnbull 2002b) or "governance board" (Murray 1998) elected on one vote per shareholder to obtain the power to act independently of any dominant shareholders.

The power of any such watchdog board would be restricted to managing conflicts so as to not jeopardize the property rights of shareholders voting on a one vote per share basis for electing directors by cumulative or other means of voting or for making any other corporate decisions involving shareholders. Some important conflicts that a watchdog board could eliminate are those between the directors and the auditor and shareholders. It does not make sense for directors to control either the auditor or the conduct of shareholder meetings at which they become accountable to members (Turnbull 2005b). A shareholder watchdog board would remove these conflicts by controlling the auditor and providing a chair for shareholder meeting. The control of the auditor by a "shareholder panel" was proposed by Hatherly (1995) as occurs in some continental European jurisdictions. This approach was proposed to the UK government in December 2004 by the National Association of Pension Funds (NAPF 2004).

The use of stakeholder councils to provide public reports on non-financial matters would reduce the reporting requirements of directors. It would also eliminate the current conflict of requiring directors to report and be accountable for their own actions and those of the company under their control. Removing reporting conflicts would also eliminate the need to audit social, environmental and ethical reports provided by the stakeholder advisory councils.

However, to avoid stakeholders making public disclosure on matters that might jeopardize the interest of shareholders; the corporate constitution could provide the shareholder watchdog board with the power to edit stakeholder reports with any differences or disputes mediated by the auditor.

There would be minimal cost in establishing stakeholder councils. Various examples are quoted by Turnbull (2005a) of their spontaneous formation without any support from the company involved. The examples cited provide evidence that stakeholders would compete to be elected to an advisory council and even donate their resources. Verbal evidence provided by a large Australian corporation to the PJCCFS was that there were substantial benefits arising directly from their CSR activities that involved establishing stakeholder advisory councils (Hansard 2005). These councils were established at the grace and favor of management rather than being established by the corporate constitution. The above discussion indicates that additional benefits could arise from advisory councils by them being established independently of management through the corporate constitution.

Rich communications between corporations and their stakeholders provides a basis for allowing many problems and concerns to be resolved privately with the company. This provides a basis for a substantial reduction in the information publicly disclosed. Only information on unresolved issues would become subject to disclosure. So while the quantity of information could be substantially reduced, the scope of public disclosure could be increased to cover any 'triple bottom' line issues not already resolved.

Public disclosure could be aimed like a rifle shot on a need to know basis. There is no longer a need for the excessive scatter gun disclosure of information on a contingency basis that it might be required by some people, in some circumstances at some times or that is required to inhibit corporate wrong doing. Corporate wrong-doings would be exposed to the disinfectant of the much more intensive

sunlight from stakeholders empowered with technical operating information with the motivation to inform corporate offices or regulators who could take corrective action.

Stakeholders with day to day operating information are in a better position to detect malfeasance and harms then directors. They can undertake this task on a much more systemic, comprehensive and intimate basis than any outside regulator. The need and role of regulators would atrophy to the degree that stakeholders became effective co-regulators. This provides the basis for governments to grant exceptions from Sections in the law for corporations that introduced self-enforcing self-regulatory constitutions that made Sections of the law redundant. In this way the role of government would change as discussed in the following section.

5.0 Changing the role of government

The self-enforcing processes introduced by corporate constitutions that establish formal engagement with stakeholders of record could be used to fundamentally change the role of government. Instead of direct prescriptive and intrusive interventions that are becoming increasingly complex and counter productive, indirect interventions would be introduced. The indirect interventions would be based on shareholders introducing government approved replaceable rules in corporate constitutions that introduced self-enforcing self-regulation.

For the reasons discussed earlier there are sound business reasons why shareholders and their directors should vote for the adoption of approved replaceable rules in corporate constitutions. However, governments could introduce additional incentives such as exception from laws and regulations made redundant by the replaceable rules. Fiscal and monetary incentives could also be used to provide incentives for any type of non-trivial incorporated organisation. The definition of a non trivial organization would need to take account the significance it's economic, social and environmental impact. A definition suggested in Turnbull (2005a) was organizations with a turnover in excess of $50 million with a combined total of 500 or more names in its books recording the number of its customers, employees and suppliers.

A self-enforcing strategy might be opposed by regulators because it could be seen to minimize their size and influence. Initiatives for change might therefore need to come from political leaders such as those involved at the political legislative level like the PJCCFS.

While the proposals in this paper are grounded in the science of governance they are also based on the empirical finding of Milgram (2004). Milgram demonstrated how systems of power can make good people act in a depraved way as occurred in Nazi Germany and with US guards in Baghdad prisons. His work explains how harms can arise from the actions or inactions of well intentioned company directors, auditors and politicians as a result of the system of power in which they operate.

The research by Milgram explains why auditors controlled by directors can fail to report when a company is about to collapse. Specific empirical research with Auditors by Bazerman, Loewenstein and Moore (2002) has confirmed the Milgram findings and how audit quality is improved when investors control the auditor rather than the directors. The practice of auditors being controlled by investors rather than by directors is found in Europe and explains why the European Parliament (2005) rejected adoption of the Sarbanes-Oxley requirement that auditors be controlled by directors.

The take home message is that it is not the duties of directors that need to be changed but the system of power in which directors operate. Another conclusion is that the behavior of corporations, their directors and management is largely determined by the institutional system in which they operate. To avoid operating or behavioral failure, corporate communications and control systems need to be designed to facilitate success. The communication and control architecture found in biota represents a very robust tried and proven system. It provides a basis for Governments, organizations, corporations and society generally to emulate as outlined in Turnbull (2002a).

As noted earlier, there is no requirement in Corporation Law for directors to maximize shareholder value. The imperative to do so in publicly traded companies is created by the way directors are appointed, awarded and dismissed. The inclusion of stakeholders into the architecture of corporate power would provide a way to create pressure for directors to consider social and environmental issues. In this way CSR could be extended to companies not publicly traded to create a level playing field for all companies that are large enough to have a significant social impact.

From the analysis presented in this paper we may conclude that change in corporate constitutions, rather than the law is required to make corporations socially responsible. Changes are required to recognize and give voice to those citizens who its operations may harm. In this way citizens could be provided a basis to protect their own interests without relying on laws, regulators or even the courts. It would also enrich democracy and enhance the political legitimacy of corporations. At the same time corporations would be able collect business intelligence with minimal cost to obtain sustainable competitive advantages.

It is very much in the interest of shareholders and stakeholders to work together as neither can profit without the other. It is in the interest of shareholders for their directors to obtain information independently of management to monitor management. As note earlier, stakeholder feedback and feed forward information enhances the ability of the firm to sustain competitive advantages. Shareholders and/or their representatives also have an interest in obtaining independent advice, as they might from stakeholders, on the performance of their directors.

The ability to obtain win-win advantages from the formal involvement of stakeholders requires the careful design of corporate constitutions. The devil is in the detail that needs to be carefully nuanced. Constitutions that had proven safeguards for protecting the public interest would provide a basis for the government to except such companies from a significant number of provisions in current laws and regulations while eliminating the need for corporate governance codes. The efficacy of governance codes are increasingly being questions with some analysts providing evidence of them being counter productive (Bhagat and Black 1999; Rose 2006).

The role of government should then be to provide the incentives for corporations to amend their constitutions to enhance their performance in way that would also make companies socially responsible to their stakeholders. A persuasive incentive to achieve these objectives as well as initiating a process to reduce the size and cost of government would be to exempt corporations from the many costly intrusive laws and regulations in return for adopting constitutions that allowed their stakeholders to protect themselves and the public interest in a more efficient and effective manner. In this way democracy and the free enterprise system would be strengthened while reducing the size and cost of government.

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