Correcting the failures in Corporate Governance Reforms
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Shann Turnbull
sturnbull@mba1963.hbs.edu

ABSTRACT
The paper identified ways in which corporate governance reforms are failing and how this situation can be corrected. A basic problem is that corporate governance is not described in outcomes that can be measured but in unmeasurable terms of principles, practices and processes. This means that there are no accepted criteria for identifying good or higher standards. A more fundamental problem is that lawmakers, regulators, and corporate governance experts lack knowledge of the natural science of governance identified only 59 years ago. The natural laws of regulation are outlined to identify why the current top down approach to governance is incompatible with the bottom up approach found in nature to regulate biota in the most efficient and effective manner to sustain their existence. A bottom up approach allows investors and stakeholders to become co-regulators. As the mission of regulators is to protect citizens, their involvement as co-regulators richly increases the ability of both firms and regulators to control business activities to improve the efficiency and effectiveness of both. The paper concludes that constructive governance reform requires Regulators; advisors to law makers and company boards to acquire the knowledge of how to apply the science of governance to firms.

Keywords: Communication; Control; Co-regulation; Governance; Regulation; Regulators; Requisite variety; Self-governance.

JEL Classification: B49; D79; G18; G28; G38, H11; K22, L51

Shann Turnbull, PhD, Principal:
International Institute for Self-governance
http://www.linkedin.com/pub/0/aa4/470
PO Box 266 Woollahra, Sydney, Australia 1350
☎️ +612 9328 7466; Mobile: +61 (0) 418 222 378
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This paper provides evidence that corporate governance reforms are failing and reform has been heading in the wrong direction. It then describes how these problems can be corrected by applying the laws that govern the regulation of living things discovered only 59 years ago by Weiner (1948).

The most compelling evidence of failure is provided by the market. The market for being a Publicly Traded Company (PTC) in the US has declined to avoid compliance with recent governance reforms. Many US companies have delisted as this can be done without shareholder approval or expense (Smartpros 2005). A number of foreign corporations have given up their US listing to avoid compliance costs (Li 2007). But most tellingly, there has been a rapid increase in Private Equity investors acquiring PTCs as this permits them to extract greater value from them as private entities (Jensen 2007).

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 provides evidence that both the law and Regulators are inadequate.

Successful reform would reduce rather than increase the cost of business. The compliance cost of Sarbanes-Oxley (SOX) legislation has been significant (Linck, Netter and Yang 2006; Ribstein 2005; Sneller and Langendijk 2007). Romano (2004) described SOX as “quack” corporate governance with Clarke (2006) noting the lack of evidence that the current “crisis driven reforms” providing positive results.

The inability of either SOX or the Australian Securities Exchange Corporate Governance Code (ASX 2007) to prevent or detect fraud and make directors accountable was revealed in 2004 by the Foreign Exchanges losses suffered by the National Australia Bank (Turnbull 2007a). The Bank complied with SOX and was judged as having the “highest standard” of corporate governance in Australia (Psaros and Seamer 2002: 13).

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

A fundamental problem is that corporate governance is described in terms of Principles, Practices and/or Processes (ASX 2007, Combined Code 2006) that are not subjected to measurement, rather than Outcomes that can be measured. As often noted it is difficult to manage what is not measured.

As there is no agreed definition of good governance, rating agencies use corporate 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 that becomes part of what Rose (2006) describes as the “Corporate Governance Industry”.

The UK combined code and 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 (Turnbull 2005). 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 (Bhagat and Black 2002). According to Clarke (2006), “The whole purpose of having independent directors is surprisingly under theorized, leading to inconsistent rules”. He goes on to say that “important elements of the concept of and rationale for independent directors remain curiously
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obscure and unexamined”. This has led Rodrigues (2007) 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. In addition, flexibility would be introduced 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 as indicated in the Appendix based on Turnbull (2007b). These outcomes should be the objectives of regulations and the mission of regulators and listing rules. But in Australia, the law and the Regulators failed to stop major corporate frauds and collapses. The ASX Corporate Governance Code was introduced to pre-empt the introduction of additional laws. This initiative has still increased complexity and compliance costs with problems still arising as shown by the National Australia Bank.

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 of stakeholders and furthering their interests. 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 (Turnbull 2002b) based on the laws of nature that regulate biota. 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 (Turnbull 2007b). Changing the role of Government in this way was proposed by the US Vice President (Gore 1996).

The constitution of organisations represents their DNA. No biota 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 directors with what Monks and Sykes (2002) refer to as “inappropriate powers”. Turnbull (2000c) identifies the excess powers obtained by directors that introduce conflicts of interest. Many conflicts arise because powers to manage the business are combined with governance powers such as director nomination, election/appointment, remuneration and auditing their accounts as well as managing the process of how the directors are held accountable to shareholders.

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 Exchanges are irresponsible in accepting the ability of corruption to be perpetuated in this way. As stated by Monks and Sykes (2002), the removal of “inappropriate powers” for directors “is thus the litmus test for any worthwhile reform of shareholder capitalism”.

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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. 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 a large corporation can neither be efficient or effective. This is because the science of governance states that it is impossible to directly magnify regulation/control (Ashby 1968: 268). Regulation and control can only be magnified indirectly through “supplementation” in the same way that it is impossible to directly magnify the signals of radio or TV transmissions. Their very weak signals require supplementation with the energy provided by the power mains.

In social organisations this means that to achieve efficient and effective regulation or control, the energy of co-regulators are required to amplify the richness of communications and control to the Regulator and/or the board of directors. It is in this way that organisations can obtain operating advantages. In particular, firms can 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 she or he controls 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 on behalf of stakeholders 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 (Shannon and Weaver 1949) and control (Ashby 1968). A corollary of these laws 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” (Turnbull 2002a). Firms in rapidly changing complex industries like Information Technology and Bio-technology are forced by competitive pressures to adopt network governance as described by Jones, Hesterly and Borgatti (1997). The competitive advantage of network governance in more stable industries has been proved by the nested networks of stakeholder controlled network firms located in Spain (Turnbull 2000b: 201). 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 the interests of all parties.

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.
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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 for facilitating self-governance 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 distributors so it is very much in the interest of shareholders for firms to formally engage and bond with its strategic stakeholders. Some suggestions on how this could be achieved by amending corporate constitutions are described by Turnbull (2000a).

Research has revealed that stakeholders typically contribute more product innovations than the internal research and development departments of firms (Hippel 1986). 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 at least some information that is 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 may not be seen. They are commonly accepted as being a “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. 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 to 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 knowledge is provided

1 An exception occurred over three semesters in 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.
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by Turnbull (2000b) who describes how the laws of natural science can be applied to social organisations. Education would still be required on how to apply natural laws to designing social institutions.

However, until lawmakers and Regulators apply natural laws to regulatory reform, reform will continue to head in the wrong direction. The time is overdue that an education in Governance Science be a perquisite for all regulators\(^2\) and other advisers to law makers. This knowledge is also required in the private sector for improving the competitiveness of firms and initiating reform from as the bottom up as undertaken by Turnbull (2000a, 2007c).

References


\(^2\) Education of UK Financial Reporting Council staff was initiated in September 2007 with a seminar based on the contents of Turnbull (2007c).
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APPENDIX

Outcome based Corporate Governance Disclosure
Summary of submission to Australian Treasury, February 14th (Turnbull 2007b)

(1) How does the board avoid or manage the conflicts of interest of self-nomination?
(2) How does the board avoid or manage the conflict of interest in determining its own remuneration?
(3) How does the board avoid perceptions of conflicts of self interest in the methods adopted to achieve outcomes (1) and (2)?
(4) How does the board avoid controlling the process of being held accountability for not achieving points (1), (2) and (3) and on their performance in general?
(5) How directors evaluate the SWOT of the management team and also of the company on a continuous, systematic, comprehensive and reliable basis without relying only on the information provided by management?
(6) How do director determine on a continuous, systematic, comprehensive and reliable basis when their trust in management might be misplaced?
(7) How do directors avoid or manage the conflict of Auditors serving two masters – shareholders and directors (including those classed as “independent”) to negate the purpose of the law appointing external auditors to express judgment independently of the directors as to if the accounts are true and fair when directors engage and pay the auditor for their judgment?
(8) Hiring, directing, controlling, retaining, remunerating and/or dismissing executive directors independently of any power, status and influence, remuneration or other benefits that executive directors may bestow on the non-executive directors;
(9) Protecting the interest of minority investors in one or more ways such as:
   (a) Dominant shareholders seeking power and influence rather than profit;
   (b) Dominant shareholders (obtaining other unfair advantages);
   (c) Dominant executives (seeking power and influence rather than profit);
   (d) Dominant executive directors (over paying themselves);
   (e) Dominant other directors (leading the company astray);
   (f) Protecting the company from unfair related party transactions;
   (g) Protecting the rights of employees (could be conflict with shareholder interests);
   (h) Protecting the rights of other stakeholders (which could be conflict with shareholders);
   (i) Protecting the company from breaching the law or regulations.
(10) By what means can each director individually obtain the will and power to act independently to further the best interests of the company?