Mindless rituals of the boardroom

How our corporate structures encourage bad habits

The government, ASC, ASX, institutional investors and some professional associations are perpetuating a corrupt, inefficient and non-competitive system of corporate governance, writes SHANN TURNBULL.

It is time to recognise the fatuousness of some of the more pompous rhetoric on “best practice” in corporate governance, and to reform the current mindless, expensive and counter-productive rituals.

No change in corporate law is required to introduce reform. Governments could use privatisation as a basis to provide models. These would show how processes can be established to provide directors with the will and ability to protect shareholders from mismanagement or the appropriation of value. In this way, corporations would become more competitive and the role and cost of government regulation would be reduced.

Self-regulation provides competitive advantages while privatising the cost of government regulation. In contrast, the existing system can corrupt management and directors, and damage corporate performance and competitiveness.

Corruption is an inherent feature of the existing system, which provides directors with excessive powers and absolute power to manage their own conflicts of interest. Since “power corrupts and absolute power corrupts absolutely”, it is no wonder that many companies underperform, with others failing from mismanagement and corruption. Excessive power also explains the excessive payments made to some CEOs.

The solution is simple: introduce a division of power to create checks and balances. Only in this way can management and directors systematically obtain the will, power, knowledge and capability to excel.

For directors to obtain the will to act, they need to be appointed on a basis which secures their board positions independently of management, or even a controlling shareholder. Providing directors with the power to act requires an independently appointed watchdog board with veto power. Providing directors with the knowledge to act requires a system for obtaining inside expert information independently of management. To endow directors with the capability to act, their role, duties and responsibilities need to be simplified.

Directors have a number of powers which create conflicts of interest while doing nothing to add value for shareholders. This is an unacceptable situation for investors in the business. It should also be unacceptable for any
Table 1: Comparison of functions and activities of unitary board and Mondragón compound board

<table>
<thead>
<tr>
<th>Unitary Board (Source: Tricker 1994:245 &amp; 287)</th>
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<tbody>
<tr>
<td><strong>External</strong></td>
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<tr>
<td>Conformance functions</td>
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<tr>
<td>Accountability</td>
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<tr>
<td>• Reporting to shareholders</td>
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<td>• Ensuring statutes regulatory compliance</td>
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<td>• Reviewing audit reports</td>
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<tr>
<td><strong>Internal</strong></td>
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<tr>
<td>Supervision</td>
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<tr>
<td>• Reviewing key executive performance</td>
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<td>• Reviewing business results</td>
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<td>• Monitoring budgetary control and corrective actions</td>
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**Appointment and rewarding of chief executive**

Short term: Long term:

**Mondragón Compound Board (no independent directors)** (Source Whyte & Whyte 1988)

<table>
<thead>
<tr>
<th><strong>External</strong></th>
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<td><strong>External</strong></td>
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<td><strong>Internal</strong></td>
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<td><strong>Internal</strong></td>
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<tr>
<td><strong>Management Board (Allocates resources)</strong></td>
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**Simplification of functions and activities in compound boards**

(Allocation of information processing labour indicated by allocation of "X")

<table>
<thead>
<tr>
<th>MONDRAGÓN COMPOUND BOARD</th>
<th>ANGLO</th>
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<tr>
<td>Control centres</td>
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<tr>
<td>Watchdog council</td>
<td>Supervisory board</td>
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<tr>
<td>Governance processes</td>
<td>Appoint Mgt. board</td>
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<tr>
<td>Efficacy &amp; integrity of processes</td>
<td>Integrate strategic stakeholders</td>
</tr>
<tr>
<td>Internal**</td>
<td>X</td>
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<tr>
<td>External**</td>
<td>X</td>
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<tr>
<td>Short term**</td>
<td>X</td>
</tr>
<tr>
<td>Long term*</td>
<td>X</td>
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</tbody>
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Omits general assembly which elects watchdog council and supervisory board

** Descriptions follow typology of Tricker (1994, pp 244, 287)


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conscientious director (or even the one without a conscience) who wants to minimise personal exposure to litigation. It certainly should be unacceptable to the Australian Stock Exchange, Australian Securities Commission, governments, auditors, accountants and lawyers.

Examples of directors’ powers which give rise to conflicts of interest are their abilities to:

- set their own remuneration and other benefits;
- establish the accounting practices which determine the reported profit by which their performance will be evaluated;
- control and remunerate the auditor who is supposed to represent shareholders;
- nominate themselves for re-election and fill casual vacancies;
- initiate changes in the corporate constitution; and
- control the conduct of shareholder meetings and voting procedures.

The conflicts of interest inherent in these powers can be eliminated by amending corporate constitutions to vest these powers in an independently elected “governance board” or “senate”. Only in this way can directors meet the requirement in the Corporations Law for them to avoid conflicts of interest.

An additional advantage of a division of power is that the role and responsibilities, and so work-load, of directors is reduced and simplified. The division of corporate powers into a “compound” board made up of directors, a watchdog committee or senate, and advisory councils of committed experts introduces “distributed intelligence and information processing”. Compound boards reduce information overload to enable ordinary people to achieve extraordinary results. This has been shown by the performance of stakeholder-owned and controlled firms around the town of Mondragón in Spain.

The table outlines the role and responsibilities of directors on a unitary board. How these roles and duties are distributed to five different centres in the stakeholder-controlled firms of Mondragón is shown in the middle part of the table. The bottom part of the table shows how the division of decision-making labour introduces a reduction in the work-load, required knowledge and responsibilities of any one individual. The table indicates that the division of decision-making power allows many more people to participate in control of the firm to enhance motivation and commitment.

Compound boards also reduce distortion, delay and biases in the information provided to management or directors. This is achieved by operational intelligence being reported to the directors by strategic stakeholders independently of management. The division of power between stakeholders introduces checks and balances to minimise conflicts, corruption and the corrosion of competitiveness. It also provides a basis for establishing trust and loyalty and for reducing transaction costs and other inefficiencies.

THE MYTH OF INDEPENDENCE

The centralisation of corporate power in a single board is the biggest governance problem for minority shareholders and other stakeholders. The next biggest problem is the conventional wisdom that a majority of directors should be “independent”. This can be shown to be nonsense, not wisdom.

It is very much in the self-interest of management, and those wanting prestigious sinecures, to promote the idea that a majority of directors should be from outside the company; that is, “independent”. This protects management in two ways:

- it nearly always ensures that the outside directors have little or no corporate or industry-specific knowledge with which to challenge management; and
- it makes directors captive to management for information, so they lose their independence.

If directors have any job to do other than advising management, it is to hire and retire management. They cannot carry out their fiduciary duty in this regard with due diligence and vigilance if their only information is that provided by management. This point is now being recognised by the courts.

Shareholders have a right to expect that directors are able systematically to collect and review informed, expert evaluation of management, independently of management. Otherwise, why have a board? It would be simpler, and much cheaper, for management to appoint an advisory committee or consultants.

If directors are to lead and motivate management, then they must be able not only to contest the views of management authoritatively but to expose the tenure of management to market forces. It is more efficient and effective for corporate control to be exercised through the boardroom rather than the stockmarket.

The method of electing directors is another defect in corporate governance. For directors to have the will to represent minority interests, some of them need to be accountable to these minority interests. This is achieved in the US through cumulative voting, which allows the composition of the

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board to reflect the composition of the shareholders.

With cumulative voting, all directors are elected each year and each share obtains as many votes as there are board vacancies. Shareholders can distribute the votes of each share over a number of directors or accumulate them for one. In this way, a shareholder with 10% of the shares can always appoint at least one director of a 10-person board. This system of proportional voting allows minority interests to elect directors even if the company is controlled by a parent entity.

When a company trades with a controlling entity, it is essential that related-party transactions can be scrutinised by individuals whose board positions are not subject to the power of those with the conflict of interest. However, the so-called "independent" directors of Australian companies hold their positions by the grace and favour of control groups. It is unrealistic to expect independent directors, in an effort to protect investors, to bite the hand that feeds them.

If directors are to have the power to act, they need the assistance of a watchdog committee to veto actions which are not in the best interests of the company or its investors. To protect minority investors against a control group, or even a parent company, a watchdog committee or senate needs to be elected on the basis of one vote per investor. While a senate veto could be overturned by shareholders voting on the basis of one share per vote, the need to make such issues public at a general meeting would avoid the most blatant frauds on the minority. It could also be used to expose excessive salaries and management stock benefits to market forces.

The most contentious and unavoidable conflicts for directors on a unitary board are their own remuneration and reappointment, and the accounting procedures used for calculating profits. Directors cannot contract out of their conflict of interest by delegating these responsibilities to a board subcommittee, as any such committee must report to the board. As a senate is appointed by the shareholders, rather than by directors, it can be used to manage all board conflicts of interest, thus protecting the reputations of directors and simplifying their role.

To obtain expert information independent of management, directors need to establish advisory councils elected by strategic stakeholders such as customers, suppliers and employees. In Japan, a keiretsu council carries out this function. A keiretsu council may meet monthly or even weekly. Its members are the chief executives of supplier and customer companies and representatives of the lead banker or trading house. These strategic stakeholders have access to inside expert information independently of management.

A problem in all management hierarchies is an unwillingness of subordinates to report problems which may reflect on themselves. This may result in the company becoming uncompetitive. Information reported through a chain of command must be condensed and this allows vital intelligence to be omitted, filtered or biased. These defects can be overcome through having information obtainable directly from strategic stakeholders.

AUDITORS — WHOSE ALLY?
The flawed rituals of appointing auditors are perpetuated by the Corporations Law and the ASC. Because auditors are beholden to management for fees, they cannot be expected fearlessly to protect shareholders with whom they may have little or no contact. Auditors are obliged by their public image to contend that they act independently. But they know that, to further their professional interest, they will give management, rather than investors, the benefit of any doubt.

Many failures by auditors to protect investors have been documented in the academic literature, which describes the differences between their role and reality as the "expectation gap". If they are to give value, auditors need to be controlled by a watchdog committee which is independent of directors and management. Otherwise, directors and management have the potential to write and mark their own examinations.

One of the most reprehensible excesses of power occurs when shareholders attempt to differ with directors at a general meeting. Propriety demands that in this situation a director chairing the meeting should stand aside to avoid the conflicts of interest arising from the chair's discretions and reserve powers on how the discussion is conducted. With a watchdog committee, this problem is avoided by having one of its members chair shareholder meetings.

FORBIDDEN FRUITS OF MANAGEMENT
A federal government proposal to allow collective investments to be managed by a single responsible entity (SRE) is a retrograde step in the protection of investors and the reduction of the role and cost of government regulation. The government has naively accepted the convenient assumption that so-called "independent" directors can protect investors. In fact, directors not associated with the owners of the management company can be denied the
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The arrangements proposed by the government will remove the need for an independent custodian of investment assets to prevent them being excessively mortgaged or appropriated in other ways. It will also neutralise the power of any investment watchdog to act against decisions of the manager.

Trustees who also act as custodians typically cost around 0.05% of funds under management; for money funds the figure can be less than 0.025%. The fees of management companies are typically around 1.5% to 2%—three times those of a professional custodian or watchdog entity.

Managers are not required to have professional indemnity insurance or put at risk more than $75,000 as a security deposit with the ASC. Rather than increase the burden of the ASC’s licensing and surveillance duties, the government should introduce incentives for investor self-regulation which would be far more effective and less costly for the government.

The professional indemnity insurance of independent custodians costs about one-sixth of their fee income. Proceeds from this insurance were used to provide refunds to investors in Estate Mortgage and Aust-Wide. With related-party custodians, this source of relief does not exist.

The government proposal for all collective investment funds to have a “compliance committee” of “independent” members could provide a way to change the relationship between managers and their investor clients, which is highly biased in favour of the managers rather than fund beneficiaries. This could be achieved through a compliance committee where:
- all its members are elected annually by the beneficiaries of the fund through cumulative voting;
- the fund auditor, and any independent custodian of fund assets, reports annually to meeting of beneficiaries and is under the control of the committee;
- no related-party transaction with the management company or any of its associates may take place without the consent of the committee;
- all communications with investors or the public are subject to the approval of the committee, which can include its own report in any communications to fund members;
- the committee approves a satisfactory level of professional indemnity insurance taken by the management company;
- committee members are paid by the management company at the same rate as professional non-executive directors;
- the committee may engage legal and other advisers or custodians for the fund, with the cost paid by the management company provided it does not exceed 6% of the fees payable annually to the manager (that is, these costs would come out the manager’s profits and so provide an incentive to maintain acceptable standards of compliance).

These proposals for sharing greater power with investors illustrates how elements of self-regulation could be introduced to publicly traded corporations. For listed corporations, the role of a compliance committee would be undertaken by a senate as described in my article in the December 1992 issue of JASSA.

It is not in the interests of honest directors to be implicated in a corrupt system. Directors who argue against the above suggested reforms are open to suspicions that:
- they cannot identify conflicts of interest;
- they are irresponsible in accepting conflicts of interest;
- they are captives of a management which does not wish to be accountable or lose its excessive benefits; or
- they are not honest.

Shareholders should demand the retirement of any director found to fit any of these descriptions. It is time for directors and shareholders to take action to get a better deal for themselves and the economy.

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