

Response of Shann Turnbull

A What role should non-executive directors perform, and how does this compare to the present position?

A1. In directing and controlling an enterprise, Non-Executive Directors (NEDs) should be in a position to continually evaluate the Strengths, Weaknesses, Opportunities and Threats (SWOT) of the company as a whole and also the ability of management to carry out their role with both information provided by management as well as comprehensive detailed information independent of management.

However, the UK system of corporate governance provides no systemic basis for NEDs to evaluate either management or the operations of the company with information that is independent of management. As a result, NEDs can not carry out their fiduciary duties with creditable due diligence and vigilance to protect the interests of themselves, shareholders, other stakeholders or any relevant regulator concerned with protecting specific stakeholders or the public interest.

A2. In addition, NEDs need to act as a "loyal opposition" to management to challenge and check their proposals. However, NEDs can be inhibited from challenging management when management can determine or influence their tenure on the board and/or obtaining the direct or collateral economic benefits of being a board member with its associated public profile, status and influence

A3. Even when NEDs have the information and will to act against the self-interest of management they may not have the power to act against management because management may be a dominant shareholder, or be appointed and/or have the support from one or more major shareholders that have private interests in conflict with the company as a whole.

B What knowledge, skills and attributes are needed, and what can be done to attract, recruit and appoint the best people to non-executive roles?

B1 This question is of secondary importance to NEDs not possessing a systemic process for obtaining information independent of management, with the will to act independently of management and the power to direct and control management. Changes in the system of corporate governance is required as described in *A New Way to Govern: Organisations and society after Enron*, so that corporations can attract and empower ordinary people to reliably sustain and protect enterprises and their stakeholders. It is physically impossible for the most gifted, talented and resourceful NEDs to protect the interest of stakeholders in large or complex enterprises with the existing system, especially on a part time basis. A government that only "re-arranges the deck chairs" of the current system is being grossly irresponsible with the life savings of citizens and in some enterprises the lives and health of customers, employees, suppliers and other stakeholders.

C Do existing structures and procedures facilitate effective performance by non-executive directors?

C1. The existing structures and procedures deny NEDs: (a) information independent of management to act against management, (b) the will to act against the interest of management or an active dominant shareholder, and (c) the power to act to protect the interests of the company as a whole and so its stakeholders. *A New Way to Govern* is required as set out in the NEF pocketbook No. 6.

Some experts cited in my working paper on '*A New Way to Govern*' have compared the existing structure and procedures with students setting and marking their own exam papers. For instance, it would be unthinkable in a court of law for the jury (shareholders/stakeholders) to only rely on information provided by the accused, (directors) or witnesses (auditors) controlled and paid for by the accused! It would also be unthinkable for the accused to count the votes of the jury as do director at an AGM when they are up for re-election. This illustrates just some of the fundamental flaws in the current system of corporate governance that are described in more detail in the NEF Pocket Book No 6.

D Do existing relationships with shareholders or others need to be strengthened?

D1. Both NEDs and the stakeholders need to be empowered to direct, control, and support corporations to further their respective mutual interests by adopting *A New Way to Govern* as set out in the NEF pocketbook Number 6 and outlined below.

E How can non-executive directors best be supported to perform their role?

E1. There are three necessary but not necessarily sufficient conditions that need to be met for NEDs to perform their role.

(i) NEDs need information to act independently of management by the corporate constitution requiring the establishment of various independently elected stakeholder councils as explained in *A New Way to Govern*. The number and type of advisory stakeholder councils would vary with the complexity and scope of the business.

(ii) NEDs need the will to act independently of management or of a dominant active shareholder or parent company by being elected by cumulative (proportional) voting. In this way they can retain their board position independently of management or even a parent company and so obtain an incentive rather than a disincentive to expose conflicts to retain their position.

(iii) NEDs need the power to act independently of management or dominant shareholders by the corporate constitution establishing a shareholder Watchdog Board. This could be in the form of "Corporate Governance Board or "Corporate Senate" elected on a democratic basis (one vote per investor) to at least veto related party transaction in which management or a dominant shareholder had a conflict of interest with the company as a whole. There are various types of watchdog boards used in various jurisdictions and an analysis of these are provided in my paper, 'Enhancing Share Price With Superior Investor Protection' available from http://papers.ssrn.com/sol3/papers.cfm?abstract_id=310499 and my forthcoming working paper, 'Corporate Watchdogs: Past, present and future?'

F In what ways is the position different for smaller listed companies?

F1. The three recommendations in response to question E also apply to small listed companies. However, the need for independently elected stakeholder councils may be reduced and even eliminated in some cases in un-regulated industries.

In any regulated industry in which the government seeks to protect the interest of stakeholders then Stakeholder Councils need to be a condition precedent for any publicly traded or other enterprise to obtain a licence to operate. This is because the science of governance states that it is impossible to regulate complexity without matching complexity. How the laws of governance are relevant to corporate regulation are set out in my article "The Science of Corporate Governance", forthcoming, *Corporate Governance: An international review*, 10:4, 256-72, October, 2002 <http://ssrn.com/abstract_id=316939>.

Likewise, the form of Watchdog Board recommended in E1 (i) would depend upon if the enterprise was operating in regulated or unregulated industry. The "Corporate Senate" form of watch dog board with only veto powers is recommended for even the smallest publicly traded company as it does not introduce additional costs. It allows high net worth individuals or any others to protect their investment without the delay, costs and uncertainty of relying on proxy fights, court action or exposure to the liabilities of being a director. A Corporate Senate would also protect the independence of NEDs and make them much more effective in carryout their duties by giving them the power to shut the stable door before shareholders loose value. A more robust form of watchdog board would be required in regulated industries along the lines proposed in the Australian Parliament as described in 'Enhancing Share Price With Superior Investor Protection' available from http://papers.ssrn.com/sol3/papers.cfm?abstract_id=310499 and my forthcoming working paper, 'Corporate Watchdogs: Past, present and future?'

G What can we learn from international experience?

There are a number of lessons from international experience cited in my working paper on '[A New Way to Govern](#)'. The most compelling lessons are provided by the ability of employee owned firms and mutual organisations to sustain themselves over generations without failure while maintaining international competitive advantages. The key common element in establishing sustainable competitive advantages is the introduction of multiple control centers to create what I describe as a "compound board" consistent with the recommendations of E1 (i), (ii) and (iii) above. Why a compound board improves competitive advantages and reduces operating risks is analysed in my paper 'Why unitary boards are not best practice: A case for compound boards', presented to the First European Conference on Corporate Governance, Belgian Directors' Institute, November 16th, 2000, Belgium's National Bank Brussels. http://papers.ssrn.com/paper.taf?abstract_id=253803

My personal experience in Australia of using a Watchdog Board to provide superior investor protection in one small start company is described in 'Corporate Charters with Competitive Advantages', *St. Johns Law Review*, St. Johns University, New York City, 74:44, pp. 101-159, Winter, 2000, http://papers2.ssrn.com/paper.taf?ABSTRACT_ID=245691 Another personal experience of using a watchdog board in a small start up company is described and

compared with others in my forthcoming working paper, 'Corporate Watchdogs: Past, present and future?'

Other matters

The Consultation Paper raised 34 discussion points. Many of these become irrelevant for many of the reforms proposed above and detailed in my Pocket Book. Some of the points are answered in my other writings. For example, discussion point 5 inquires as to the "the main potential conflicts of interest that may arise within a company". The actual conflicts of interest that must always arise with a unitary board with absolute power to manage its own conflicts of interest are detailed in my article referred to above on 'Why unitary boards are not best practice: A case for compound boards'.

The intrinsic conflicts of interest created in a unitary board means that they cannot be avoided by "changing the deck chairs" in regards to discussion point 18 on the "composition and duties of Audit Committees". This point is backed up by the academic literature and the failure of audit committees to prevent corporate collapses. Some academic references supporting this point are:

- Hatherly, D.J. 1995, 'The case for the shareholder panel in the UK', *The European Accounting Review*, 4:3, 535-553.
- Bazerman, M.H., Morgan, K.P. & Loewenstein, G.F. 1997, 'The impossibility of auditor independence', *Sloan Management Review*, Summer Issue, 38:4.
- O'Connor, S.M. 2002, 'The Inevitability of Enron and the Impossibility of "Auditor Independence" Under the Current Audit System', Working Paper, University of Pittsburgh School of Law, <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=303181>.
- Bainbridge, S.M. 2002, 'A Critique of the NYSE's Director Independence Listing Standards', University of California, Los Angeles - School of Law, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=317121

Please note that all the proposals for fundamental reform suggested above and in my pocket book do not necessarily require any changes in existing laws. They can be introduced through changing corporate constitutions. The requirement for corporations to change their corporate charters can be introduced through the rules that allow their shares to be publicly traded and/or through their licence to operate by various regulators.

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