Re-thinking Directors Duties, Governance and Regulation

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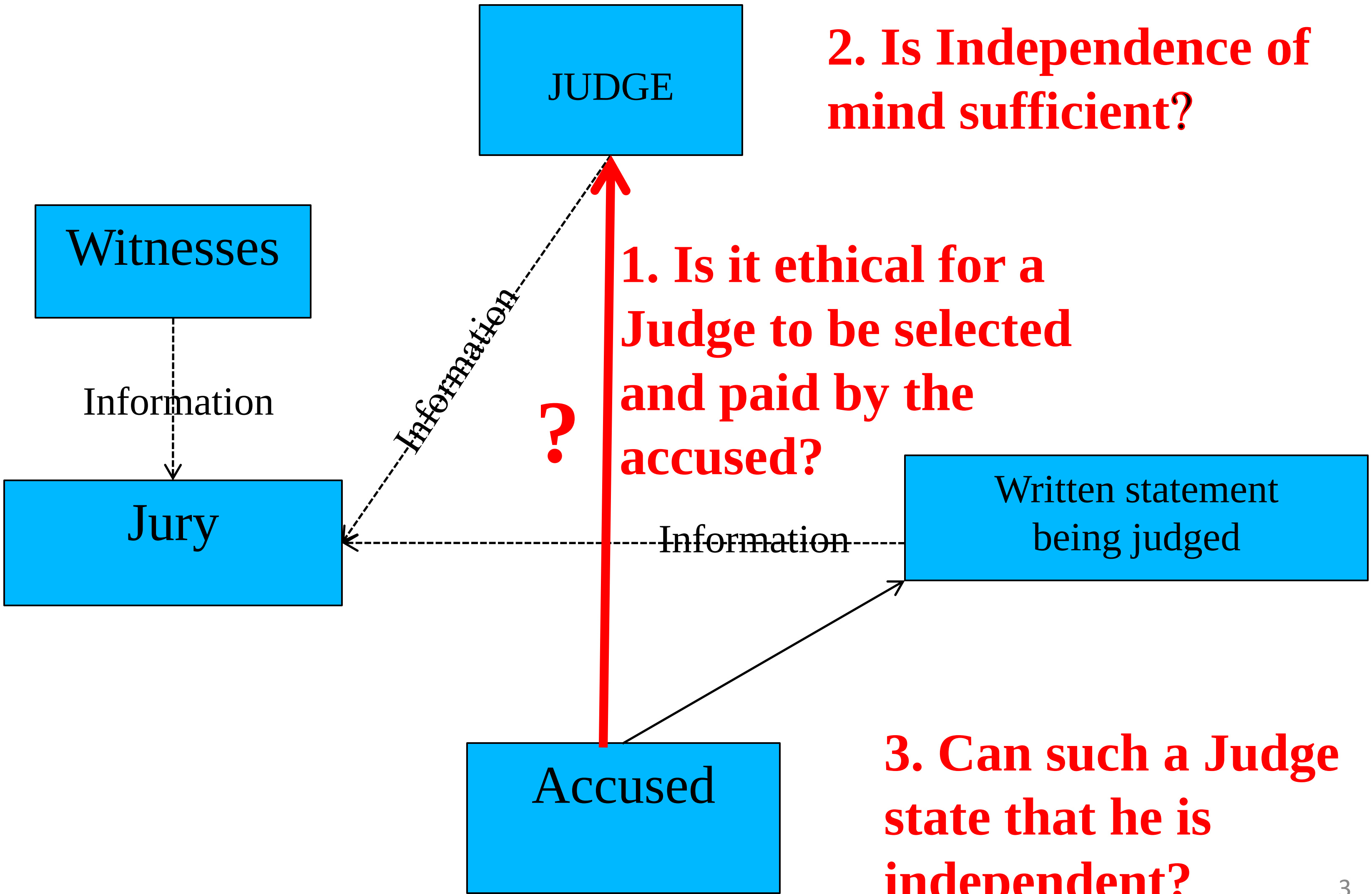
Questions about ethics

- As a starting point I would like to seek your views on ethics

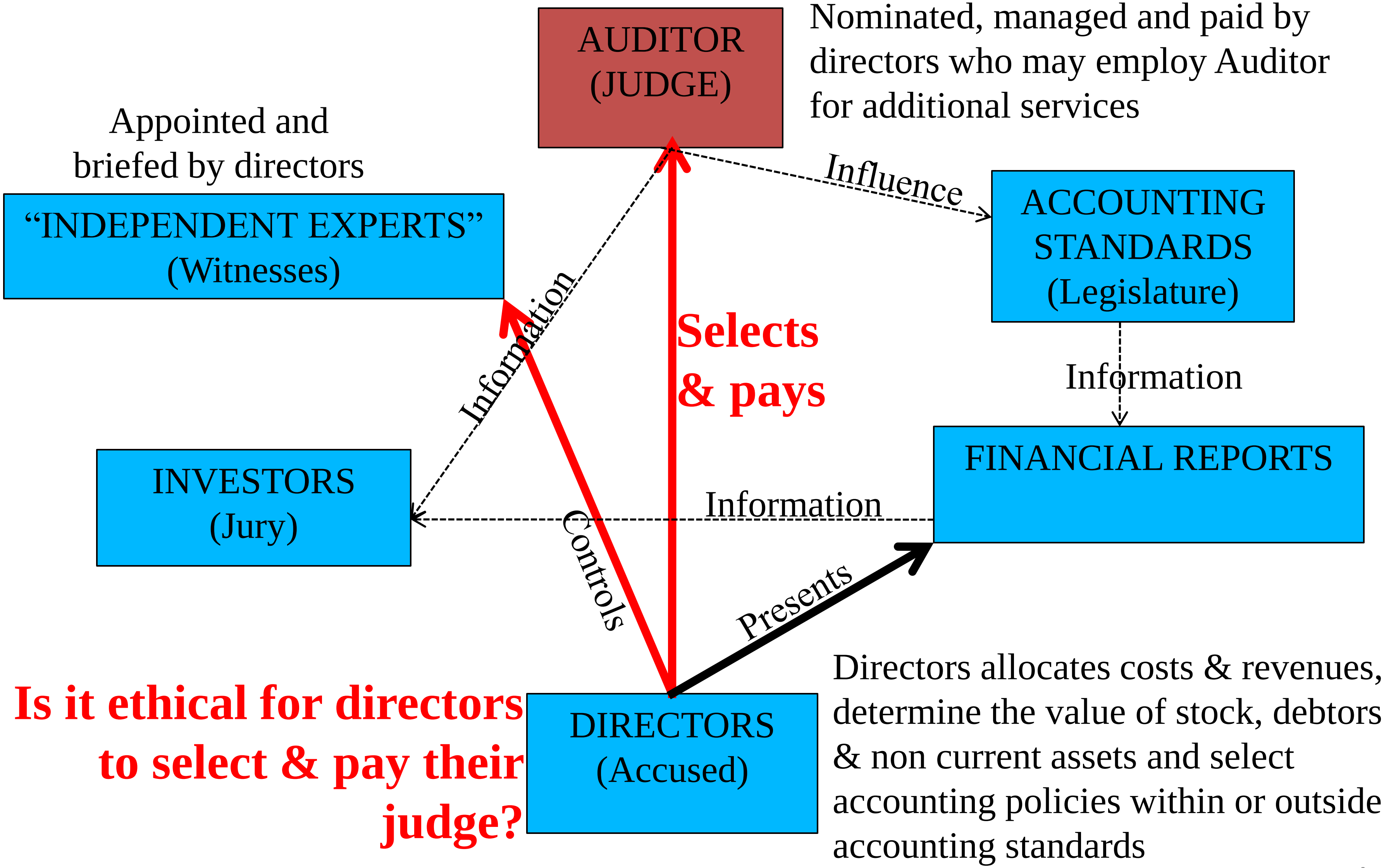
- Might the experts here today advise me on the three **questions in red** on the next slide ?

ETHICAL STANDARDS OF A LAW COURT

Is organisational <u>structure</u> and/or <u>culture</u> important?



Is it ethical for Auditors to attest they are "independent"?



Is it ethical for directors to select & pay their judge?

Governance quiz

A general requirement of the law is for directors to act ethically and in good faith and avoid conflicts of interest.

1. Why then do we have governance codes, regulators and laws that force directors into unethical conflicts by forming audit committees to select and pay those who judge their accounts?

2. Should not the audit committee be made up of a shareholder appointed committee as proposed by the 1862 UK Act and as occurs in Europe?

Other best practice puzzles

① How can any director be independent of a major shareholder?

② Even without a major shareholder how can any "independent" director obtain the incentive and/or the power to act?

③ How can independent directors who by definition possess less firm specific and/or industry knowledge are best suited to add value or be monitors of management?

④ Can directors carry out their fiduciary duties with due care, diligence and in good faith to monitor management with information provided by management?

⑤ What processes do non-executive directors possess to discover when their trust in management might be misplaced

Network governance found in all living creatures resolves conflict problems and introduce benefits

1. How can **ANY** director be called "independent" if they are compromised by conflicts with auditors who provide "intelligence" to shareholders for making decisions on how to vote on director pay and/or re-election?

   UK Law Lords in the 1990 Caparo case determined that the reason for an audit is governance not economic as forced upon the world by US law and auditors.

1. If absolute power corrupts absolutely are shareholders and regulators irresponsible in allowing directors to possess absolute power to corrupt themselves and the business in deciding when they have conflicts of interests and how to manage them? Division of powers in shareholder agreements provide win win solutions.

Puzzle answered by the science of governance

Q. How can creatures with small brains and little intelligence manage to survive in unknowable dynamic complex environments when firms governed by highly intelligent humans with much bigger brains cannot?

A. Because they have:

(i) Network governance that has both top-down and bottom-up control and communications systems, (unlike hierarchies) and,

(ii) They use contrary behavior (inhibited in hierarchies and board-room culture) that provide both checks and balances and also a rich menu of responses to manage risks and opportunities.

The science of governance

- MIT mathematics professor Norbert Wiener identified in 1948 a new science that has its own foundations described as “cybernetics” - years after relativity theory.
- Wiener defined it as “the science of control and communication in the animal and the machine”.
- The science is used for designing automatic elevators, self-regulating machinery, self-governing space probes and explains how DNA has made animals self-regulating and social creatures self-governing by being hard wired to possess contrary behavior to create “Tensegrity”
- My PhD research identified how the science can be applied to social organisations to make it the science of governance and to establish a “science of corporate governance” grounded in the natural sciences.

Network governance – separation of powers is first step

Conflicts avoided and/or creditably managed

Shareholders

One cumulative vote per share per director

One vote per investor

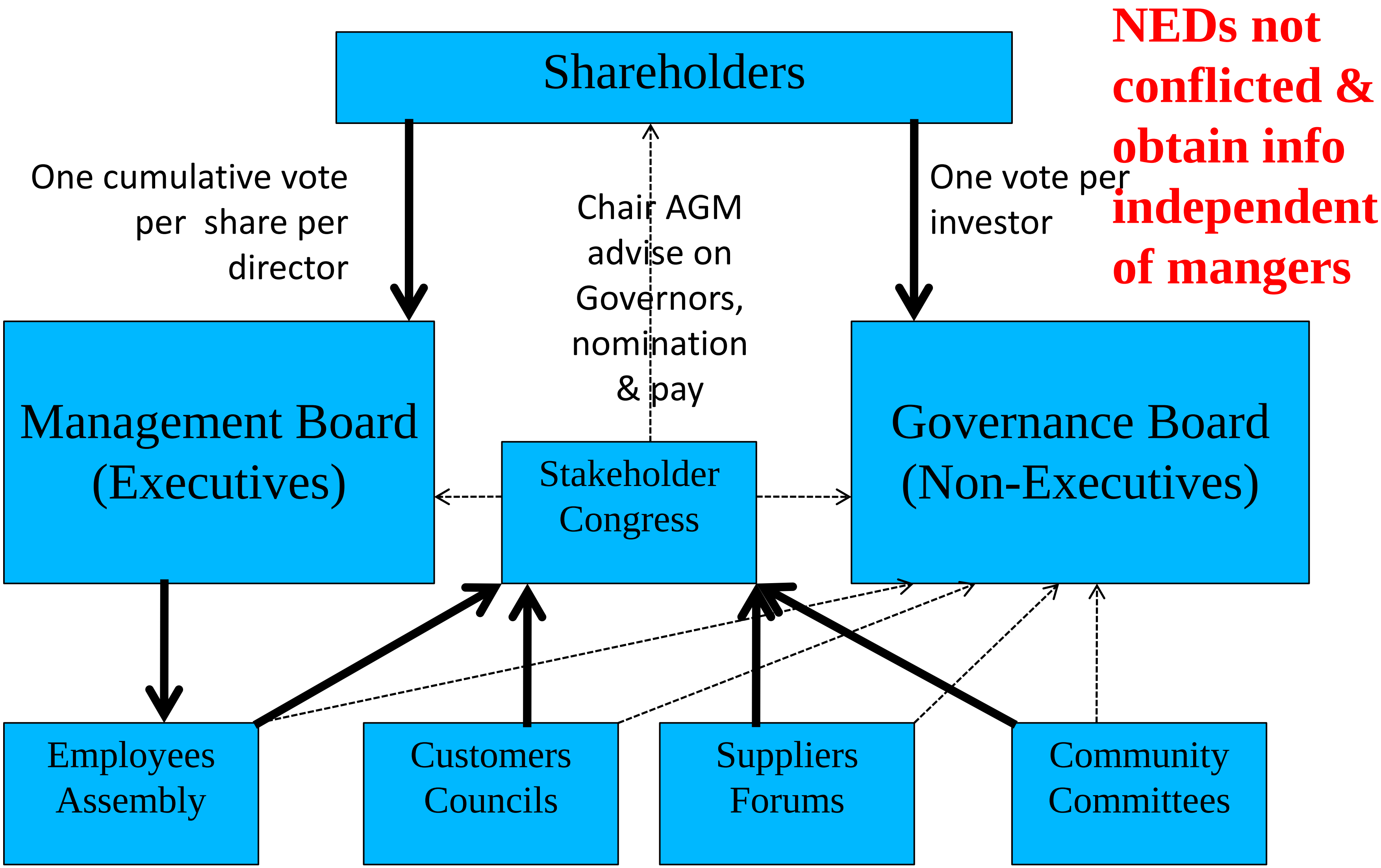
Management Board (Executives)

Manages business (subject to veto of governors only if conflict arises)

Governance Board (Non-Executives)

Control and pay external and internal auditors, other advisors, director nomination & pay. Chair AGMs

Network governance – Bottom up added to top down

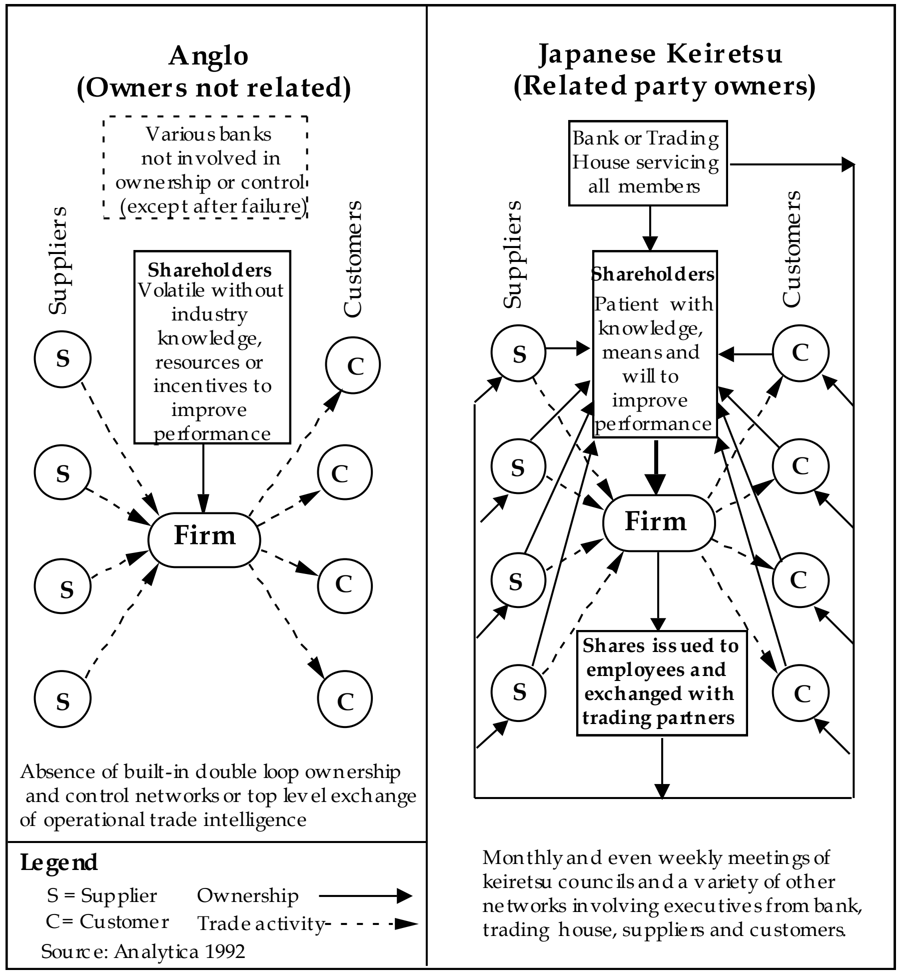


Examples of network governance

The sustainable operating and competitive advantages of network governed are illustrated by:

- The **John Lewi**s Partnership is the largest retailer in the UK with 69,000 employees who have been its only owners since 1950. Like all other non-trivial sustainable employee owned firms it has a network of boards.
- The **Mondragón** stakeholder owned cooperatives first established in Spain in 1957 now have over 60,000 employee owners operating a network of over 200 firms governed by a network of over 1,000 boards.
- **Visa** International Inc has been owned by its competing customers since 1976 in the US and has over a hundred boards each with absolute power over a function or geographic area.

Disconnected US/UK capitalism Vs Connected Japanese governance



Disconnected US/UK capitalism (Lehman)

Parties listed below not constructively connected:	Risk mitigation requires constructively connecting A+B+C+D			
	A Possess risk information?	**B** Possess the will to act?	**C** Possess power to act?	**D** Possess capability?
Shareholders	No	Maybe?	No	Yes
Directors	Inadequate	No	Yes	Yes
CEO/CFO	Mostly	No	Yes	Not alone*
Executives	Yes	No	Yes	Not alone*
Operational stakeholders	Yes	Yes	No	Not alone*
Commentators	Some	Probably	No	No
Regulators	Insufficient	Maybe?	Yes	Not alone*

Network-governance competitive advantages

- Stakeholder engagement through multiple boards introduces sufficient complexity to control complexity (Creates co-regulators to allow amplification of control).
- Stakeholder loyalty and commitment to provide cost effective services to the efficient operations of the firm.
- The role of NEDs is legitimatized by them obtaining feedback from stakeholders on the performance of the company, its executives and its goods/services independently of management.
- Management obtains access to 90% of" the source of product innovations from "lead users" (Hippel 1994) and competitive intelligence.

Network-governance advantages

- Non- Directors (9)
- Auditors (4)
- Management (6)
- Other stakeholders (4)
- Regulators (3)

Advantages of network governance for: Non-executive directors (NEDs)

1. Role simplified and information overload reduced by the decomposition of decision-making labor that also minimizes compliance responsibilities;
2. Monitoring and supervisory role legitimatized by obtaining access to a rich variety of rich information to evaluate management and the business independently of management;
3. Ability to cross check management reports for errors, biases, omissions and spin;
4. Formal and informal access to industry, product and competitive intelligence and/or whistle blowers from systematized stakeholder engagement;
5. Creditable processes established on an independent systemic basis for learning when trust in management might be misplaced;
6. Exposure to most financial liabilities transferred to full time executives;
7. Unethical conflicts with financial auditor eliminated with exclusive control of internal auditor;
8. Residual conflicts on their own pay and tenure taken over or mediated by stakeholder congress;
9. Intelligence on Key Performance Indicators (KPIs) provided by stakeholders who management service

Advantages of network governance for: Auditors

1. Unethical conflicts removed by no longer being selected, appointed and remunerated by the individuals whose accounts they are judging;
2. Removing questions about auditors not really being independent of directors and/or management and so the need to introduce audit partner or audit firm rotation;
3. Access obtained to a rich variety of alternative communication channels to cross check the integrity of data independently of management;
4. Remove unconscious bias in audit judgments as revealed by research into how good people do bad things.

Advantages of network governance for Managers

1. Formal relationships established to facilitate and/or arbitrate Total Quality Management (TQM) and Just in time (JIT) processes with relevant stakeholders;
2. Process for accessing innovational, operational and competitive intelligence from stakeholders that might not otherwise be provided on a systematic basis;
3. Facilitate stakeholder loyalty and engagement to constructively support the firm;
4. Systematic process to quickly learn about problems and take corrective actions before governors;
5. Harness pro-bono stakeholder resources for continuous improvements;
6. Compliance processes integrated into management

Advantages of network governance for: Stakeholders

1. Formal access to contribute to continuous improvement programs for mutual benefits;
2. Direct access to correct poor quality goods/services and relationships;
3. Direct, quicker and more responsive access to protect and further their own interest than regulators, courts of public protests;
4. Strengthen constructive working relationships and mediate others.

Advantages of network governance for: Regulators

1. Amplification of regulation through stakeholder supplementation as co-regulators;
2. Higher integrity of monitoring communications through multiple stakeholder feedback;
3. Improved formal and informal access to monitor and control firm compliance;
4. Role changes from directly supervising operations to promoting and supervising the integrity of firm self-regulation in protecting public interest.

	Systemic problems of “best” practices for directors	Systemic solutions from introducing network governance used by nature
1	Suspicion by outsiders that the absolute power of directors to identify and manage their own conflicts of interest might corrupt the directors and/or the business.	Corporate charter establishes a governance board of NEDs and a management board of executives. Executives elected by cumulative voting with one vote per share and NEDs with one vote per investor. NEDs control internal/external auditors, director nomination and pay with veto powers when conflicts exist for executives.
2	No creditable systematic process for directors to determine when their trust in management might be misplaced.	Corporate charters makes provision for any class of stakeholders to elect a representative board to meet with governors independently of management to provide feedback and/or feed forward competitive intelligence to them and/or managers.
3	Exposure to personal liabilities and loss of reputation from management misdeeds	Misdeeds of executives are the responsibility of the executives, as NEDs (Governors) do not have power to manage business operations.
4	No systemic access to information opposing management views and so for evaluating management independently of managers.	Feedback from establishment of one or more “Employee Assemblies”, “Creditors Councils” and “Debtors Forums” who may appoint a “Stakeholder Congress” to advise on KPI’s used to determine executive appointments and their remuneration
5	No diversity of information sources to cross check integrity of management information or obtain second or more opinions	Diversified feedback provided from specialized stakeholders groups and their Boards with informal access to Government regulator who chairs their Stakeholder Congress. Congress manages AGM that determines the pay and election of NEDs & Executives.
6	Coping with data and information overload	Compliance information and liabilities transferred to executives with option of strategic analysis transferred to a supervisory board as found in Europe.

	Systemic problems of "best" practices for directors	Systemic solutions from introducing network governance used by nature
7	Difficulties in detecting biases, errors and omissions in reports from managers	Access to a requisite variety of independent cross checking sources of information to obtain accuracy as much as desired as demonstrated by Shannon and Weaver (1949)
8	Inadequate knowledge for complex decision making	Simplification of decision making by decentralization into to a requisite variety of centers as described by Von Neumann (1947)
9	Board decision-making subject biases in its membership – Gender biases, etc.	Exposed to multiple diverse and contrary viewpoints raised by stakeholders to force consideration of taboo topics and avoid culture of don't ask don't tell.
10	Lack of will to act against management	Governors (NEDs) no longer captive to management information and/or powers and influence with independent power and/or influence on executive pay and tenure
11	Lack of a systemic way to safely blow the whistle on errors, misdeeds, etc.	Provided privately by network of boards connected to the government regulator and/or firm specific employee ombudsperson
12	Impossibility of *directly* controlling/countering complex variables/risks	Control amplified *indirectly* through requisite variety of stakeholders acting a co-regulators (Ashby 1957: 265)

Closing comments:

1) Growing appreciation that NEDs and audit committees are ineffectual, unethical, conflicted, counterproductive, for directors, shareholders and regulators.
2) Incremental de-regulation becomes possible to negotiable from demonstrating superior and creditable element of self-regulation.
3) I invite educators at universities and professional bodies to teach the 40 hour MBA unit I designed to teach how to become a self-governance corporate architect for the public, private or non-profit sectors.

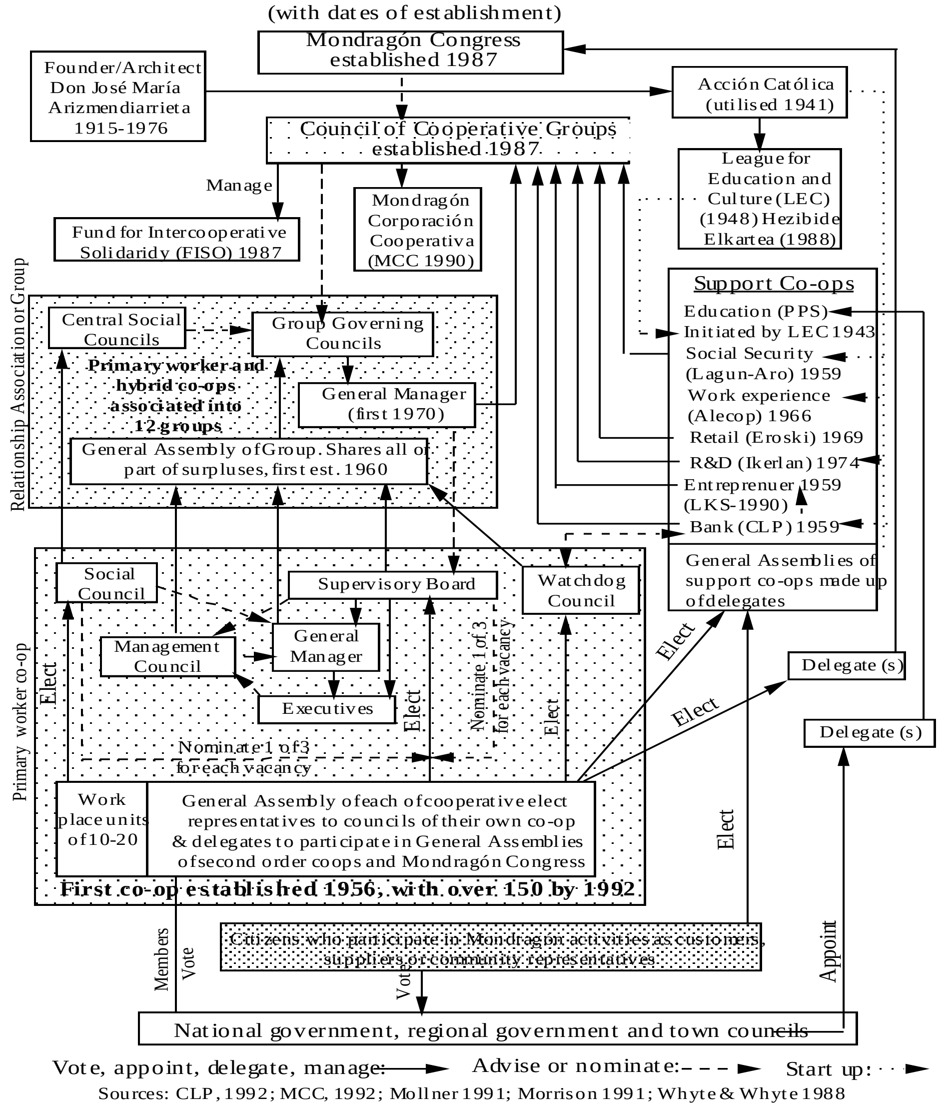
Illustration of Network Governance - 1

Mondragón Corporacion Cooperativa (MCC).

12 Relationship Groups

150+ Primary cooperatives

60,000+ worker owners



Evidence of Network governance superiority

Functions and activities of a unitary board
(Tricker 1994: 245 & 287)

	Conformance functions	Performance functions
External	*Accountability* • Reporting to shareholders • Ensuring statutes regulatory compliance • Reviewing audit reports	*Strategic thinking* • Reviewing and initiating strategic analysis • Formulating strategy • Setting corporate direction
	Appointment and rewarding chief executive	
Internal	*Supervision* • Reviewing key executive performance • Reviewing business results • Monitoring budgetary control and corrective actions	*Corporate policy* • Approving budgets • Determining compensation policy for senior executives • Creating corporate culture
	Short term	**Long term**

Decomposition of decision of making labor: Mondragón compound board compared with unitary board

TYPE	MONDRAGON COMPOUND BOARD					ANGLO
Control centers [a]	**Watchdog Council**	**Supervisory board**	**Management Board**	**Social Council**	**Work Unit**	**Unitary Board**
Members	3	5-8	4-6	~5-25	~10-11	~4-12
Functions	Governance processes	Appoint Mgt. Board	Organise operations	Worker welfare	Production, elect Social Council	Manage
Activities	Efficacy & integrity of processes	Integrate strategic stakeholders	Efficient allocation of resources	Establish working conditions	Job evaluation of pay rates	Direct & control
Internal[b]	X		X	X	X	XXXX
External[b]	X	X				XX
Short term[b]	X		X		X	XXX
Long term[b]		X		X		XX

[a]Omits General Assembly that elects Watchdog Council and Supervisory Board
[b]Descriptions follow the typology of Tricker (1994: 244 & 287)

Figure 1. Generic example of network governance for banks
Shareholders establishing a watchdog board and stakeholder councils through changing the corporate constitution