Why Anglo corporations should not be trusted: And how they could be trusted.

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ABSTRACT

This paper identifies eight reasons why it is rational not to trust large complex Anglo corporations and how these reasons could be removed. Two reasons are that directors are overloaded with information but also lack information independent of management to evaluate management and the business. A third reason is that directors do not have systemic processes to discover if their trust in management is misplaced. A fourth and fifth reason is that directors have absolute power to manage their own conflicts of interest and a dominant shareholder can enter into related party transactions that can unfairly extract value. The sixth and seventh reasons are the incentive for directors not to blow the whistle on their colleagues and the impotence of a director to act alone. The eighth reason is that shares can be manipulated and traded covertly. Four changes in corporate constitutions are identified that could remove these concerns. These are to establish a watchdog board, introduce cumulative voting for directors, establish stakeholder councils and introducing sunlight share trading.

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1.0 Why it is rational not to trust corporations

If shareholders, stakeholders and the public are to trust corporations we need to consider why corporations should not be trusted. The Anglo system of corporate governance creates at least eight reasons why they should not be trusted as summarised below:

1. Information overload that makes it impractical for directors to monitor complex and/or dynamic businesses with monthly meetings.
2. Lack of information independent of management for directors to determine the Strengths, Weakness, Opportunities and Threats (SWOT) of management or the business.
3. Lack of systemic process for directors to discover when their trust in management might be misplaced.
4. Expropriation by dominant shareholder or management who can determine the appointment of each director and the auditor.
5. Absolute corruption from absolute power of directors to manage their own conflicts of interest.
6. Non-Executive Directors (NEDs) lacking the will to act in the best interest of the company.
7. NEDs lacking the capability to act alone in the best interests of the company.
8. Share can be covertly traded and/or manipulated by insiders.

Details of each of these eight reasons are presented below:

1.1 Information overload

It is to reduce information overload that executives limit their span of control of subordinates who report to them. For a similar reason large complex firms adopt Multi-division form of organisation (Williamson 1985: 279–283). As noted by Williamson (1975: 21) humans are subjected to “physical limits take the form of rate and storage limits on the powers of individuals to receive, store, retrieve and process information without error”. Downs (1967: 116–8) has shown how information is typically subjected to more biases, errors and missing content as the number of levels in a hierarchy increases.

As society moves from the information age to the knowledge age, the complexity of business exacerbates the problem of information overload and the related problem of “bounded rationality” (Hayek 1945: 527). Unless “A New Way to Govern” (Turnbull 2002) is adopted as outlined below, the lack of trust in corporations will increase as the complexity of business and society increases.

1.2 Lack of information independent management

At the same time directors are increasingly being overloaded with information beyond their physical ability to process, they lack information independently of management to cross check the integrity of management reports or evaluate management.

Directors not only have duty to monitor the business operations but also management. This is one of fundamental reasons why shareholders appoint directors. Directors have a fiduciary duty to monitor management with due care, diligence and vigilance. Likewise, fiduciary shareholders, like pension funds, have a duty of care not to invest in companies where there are no systems in place to provide compelling evidence that directors are performing their fiduciary duties. There is no rational basis to trust companies where directors do not have a rich, knowledgeable source of information independent of management to advise them on the SWOT of the managers and the business.
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1.3 Lack of systemic process for directors to discover when their trust in management might be misplaced.

If directors do not have any systemic process to obtain rich information on the SWOT of management and the business then they are not likely to have a basis to discover when their trust in management might be misplaced. As Anglo corporations typically have no such processes then shareholders, stakeholders and the public have no rational basis for trusting corporations. Indeed, investing in such companies is being irresponsible.

Fiduciary investors like trustees of pension funds cannot be irresponsible. It is difficult to comprehend how it is legally possible for fiduciary agents to undertake their role with “due care” of investing funds of their beneficiaries in any company where directors do not have systemic basis for discovering when trust in management might be misplaced. When questioned on what systems they may have the common answer by NEDs is that they rely on the auditor, industry analysts and/or the regulator.

This is irresponsible buck-passing for two reasons. First, the auditor, analysts and regulators mostly rely on the information provided by directors. Second, the directors have much greater access to information and they have much broader responsibilities than auditors, analysts and regulators. If directors carry out their role by simply trusting management then it would be cheaper for shareholders to do the same thing and not have NEDs!

1.4 Expropriation by dominant shareholder or management

A large majority of Publicly Traded Companies (PTCs) around the world has a single dominant shareholder with the power to appoint or dismiss all directors and the auditors (Porta, Lopez-de-Silanes, & Schleifer, 1999). “Even in the United States, the founding family is an influential investor in more than one third of the standard & Poor’s 500 companies” (The Economist 2003). This makes NEDs powerless and/or unwilling to prevent a dominant shareholder and/or dominant management expropriating value from the company. So there is no sound basis for trusting companies in this situation.

However, like many scholars who assume that all PTCs have ownership separated from controlled, as observed by Berle and Means (1932), the presence of dominant shareholders was not taken into account by UK review into “The role of and effectiveness of independent directors” (Higgs 2003). This omission was revealed when Derick Higgs was questioned during his presentation in Amsterdam to the annual meeting of the International Corporate Governance Network (ICGN 2003).

The ability of directors to act independently becomes trivial when a dominant shareholder is present and so makes the recommendations of the Higgs Review ineffective. Even without the presence of dominant shareholder, recent corporate failures and the excessive remuneration of management approved by NEDs indicates the ability of management to dominate and capture NEDs. This means it is not rational to rely on NEDs to prevent expropriation of shareholder value, management hubris and self-serving misstatement of the financial position.

1.5 Absolute corruption

Corporations governed by a single (unitary) board have absolute power to manage their own conflicts of interest (Turnbull 2000). It is widely accepted that absolute power leads to absolute corruption as forcibly illustrated by many of the high profile corporate failures.
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Anglo corporate laws and practices are inconsistent with the approach adopted by the framers of the US constitution and the insights of Adam Smith (1776). Unlike the US constitution that has a division of power to check against corruption, no such division of power is required in USA and UK corporations. Adam Smith stated that business people “seldom gather together except to conspire against the public interest”. But Anglo corporate laws and practices are based on the opposite assumption that when directors gather together they will always be good fiduciary agents putting the interest of others above their own.

As a result Anglo directors have a number of powers that create conflicts of interest and the opportunity to serve their own interest ahead of the company and its shareholders and/or to entrench their position, status and influence to serve their own interests. For example, directors have absolute power to determine the terms of related party transactions and the basis of being accountable to shareholders by determining the conduct of shareholder meetings.

The purpose of an Annual General Meeting (AGM) is for directors to present the accounts and become accountable to shareholders. But corporate constitutions typically provide directors with pre-emptive rights to determine not only the method of electing directors but also the way the meeting is conducted. This creates a conflict of interest by allowing directors to control the manner in which they are accountable and elected.

Because directors can treat shareholders unfairly, many shareholders do not bother to attend AGMs. If governments were serious about wanting shareholders to control directors rather than regulators they would make it illegal for any director, officer or agent beholden to directors to chair any meeting of shareholders. It is only common sense. An independent chairman could control a meeting much more efficiently and effectively when not compromised by trying not to appear to be acting in his self interest to protect the directors against criticism.

An independent chair would also avoid directors acting unethically. Textbooks on the running of meetings like Renton (1979) and Shackleton (1973) point out that it is unethical for anyone to speak for or against a motion from the chair as commonly occurs at shareholder meetings of PTCs.

Why should people trust corporations when chairman who have the very best intentions act in an unethical manner? Fish rot from the head. Company chairman routinely provides evidence of rot being universal in PTCs.

1.6 NEDs lacking the will to act in the best interest of the company

The excessive power possessed by chairman of Anglo corporations can deny the will of NEDs to act against the chair even when there is no dominant shareholder.

The constitutions of Anglo corporations typically provide the chairman the power to determine both the conduct of AGMs and the method of electing directors. In addition, constitutions typically state that no shareholder has the right to raise any dissenting motion against the chair as to how the discretion of the chair is exercised. In this way Anglo corporate constitutions make the chair a dictator and any unethical actions legal.

The effect of these provisions to make NEDs beholden to the grace and favour of the chairman to retain their board position. So while healthy discussion at a board meeting might encouraged the self-interest of NEDs and the need to be loyal and be seen as a “good team player” on the board provides serious disincentives for NEDs to act against the wishes of the chair.
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It is not rational for investors to trust that NEDs can possess the will to act against a dominant chairman representing a dominant shareholder or dominant management.

1.7 NEDs lacking the capability to act alone in the best interests of the company

Even if NEDs have the information and will to act against the views of management and board colleagues this is not sufficient to protect the interest of the company as a whole unless there are a majority of directors who support the action. The fairness of related party transactions with a dominant shareholder or with other board members is a matter in which there can be honest differences of opinions. However, the Anglo system of governance does not provide a process to consider or even mediate differences of opinion.

The only recourse an individual has to act alone is to resign in protest. But retirement benefits for the NED and the prospect of the NED being invited onto other boards would be jeopardised if they made public their reasons for resigning was because of a dispute. Especially so if the reason was over the value of payments to executive officers or colleagues or other related party transactions.

1.8 Share can be covertly traded and/or manipulated by insiders

As corporations, stock exchanges and regulators allow shares to be publicly traded without public disclosure of the ultimate beneficiaries and/or controllers there exists the opportunity for insiders to trade covertly and/or manipulate prices. It is not rationale for shareholders to trust corporate insiders to disclose their interests when there are substantial economic incentives in being covert.

The fact that directors are required to disclose their share dealings after they have executed a trade protects neither the reputation of the director or protects the financial interests of the counter party who unwittingly deals with an insider.

In an earlier age when stockbrokers recorded share prices on a chalkboard they had the ability to establish their own rules for trading shares. The rules adopted allowed brokers to covertly trade shares ahead of their clients. Governments have now licensed stock exchanges in the electronic age to continue this unconscionable practice of investors not being allowed to know with whom they are dealing. This prevents the market place from identifying which traders are undisclosed insiders and so the ability to obtain compensation from being deceived and misled. Instead, regulators spend public money to undertake the monitoring of public markets but without the information of the market place to identify who is an insider or share manipulator.

2.0 Building trust in corporations

To mitigate, reduce and/or avoid the reasons for not trusting corporations A New Way to Govern is required (Turnbull 2002). This can be introduced without any changes in laws or regulations. Only changes in corporate constitutions are required. These could be introduced unilaterally by shareholders.

However, shareholders that have the most need to trust corporations are those that are the most powerless to act. Dispersed shareholders in the USA and the US typically lack the information, will and power to act to initiate meaningful change. The most opportune time to introduce change is at an Initial Public Offering (IPO) when venture capitalists loose the protection of a shareholders agreement and need alternative protection until they can dispose of their shares.
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Otherwise, change may need to be initiated by regulators and the regulators may need to be instructed by government to initiate change. This is because *A New Way to Govern* would reduce the size and cost of regulators. The proposed changes would also make many provisions in corporate law, listing rules, codes and guidelines redundant to simplify compliance processes and costs. How and why this can be achieved is next considered.

3.0 Providing compelling processes to trust corporations

To provide compelling reasons for trusting corporations four changes are required in corporate constitutions. Three of these changes make changes to the power and decision making structure of corporations to provide a rational basis to overcome the first seven reasons for not trusting companies as discussed above. The fourth change provides a basis to trust that insider share trading is minimised by it being made transparent.

The first seven reasons why it is not rational to trust PTCs with a unitary board are listed the left-hand column of Table 1. Corporate flaws and remedies. The reasons why it would become rational to trust PTCs that introduced first three changes in their constitutions are listed under each change in the next three columns. An additional fourth constitutional change to expose inside traders in any PTC is presented in the last row.

Table 1. Corporate flaws and remedies

| Why it is not rational to trust PTCs governed by a unitary board | Reforms to provide a rational basis to trust PTCs |
|---|---|---|
| 1. Information overload | Compliance information simplified and separated | Rich routine information reduced to that which is critical or sensitive |
| 2. NEDs lack information to act | Information improved by being independent | Alternative spin and new information provided |
| 3. Misplaced trust not detectable | Rich knowledgeable assessment of managers |
| 4. Absolute power to corrupt | Avoided by veto power over conflicts | Power of alternative and/or new information |
| 5. No checks on dominant shareholder | Counters domination with veto power | Eliminates hegemony of management intelligence |
| 6. NEDs lack will to act | Encouraged to act by discreet and effective process | Independent constituency provides will |
| 7. NEDs lack capability to act | Provides capability for NEDs to be effective |
| 8. Share manipulation | Disclosure of ultimate owners/controllers of all shares (3.4) |
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The four provisions required in corporate constitutions to allow trust to be rationally established by shareholders are:
1. A democratically elected oversight committee to control or manage board conflicts
2. Advisory councils independently elected by each strategic stakeholder constituency
3. Cumulative voting for directors
4. Disclosure of ultimate owners/controllers of all shares

The purpose of many of the detailed prescriptive provisions in corporate laws, regulations, stock-exchange listing rules and codes of behaviour are to protect minority investors and shareholders. Most of these provisions could be removed by providing power to minority shareholders to protect themselves from oppression by either management or a dominant shareholder.

Likewise, the need for manifold prescriptive provisions in the many laws, regulations and codes to protect employees, customers and suppliers including the host communities of a firm could be minimised by corporate constitutions providing stakeholders with the power to influence the behaviour of the company.

As no corporation can exist and/or provide competitive advantages without the support of its stakeholders it is very much in the interest of the shareholders to provide stakeholders with the power to advise them and management of any problems and opportunities that they may identify. Research by Hippel (1988) has revealed that 90% of innovations introduced by firms originate from the users of goods and services rather than from the research and development department.

It is only by obtaining feedback and feed forward information from stakeholders can directors obtain sufficient variety and richness of information to carry out their fiduciary duties with sufficient due care, diligence and vigilance. Just as importantly, constitutionally established stakeholder advisory councils provides basis for both shareholders and directors to obtain information independently of management on the SWOT associated with the business and/or management,

But the most important step in establishing a rational basis to trust PTCs is to introduce a division of power by establishing a democratically elected watchdog board.

3.1 Democratically elected watchdog board

There are various ways shareholders can establish a watchdog and/or audit board as illustrated in Japan (Charkham 1994: 92), France (Analytica 1992: 104), Spain (Turnbull 1995) and Russia (Gitin 2002) or proposed in the US by Monks (2003). No matter what powers a watchdog is given, a basic requirement is that they can counter the power of any dominant shareholder that can determine the appointment and remuneration of the directors and auditor. This requires watchdog boards to be democratically elected on the basis of one vote per investor to counter the usual plutocratic method of voting of one vote per share.

A very cost-effective type of watchdog board that I established for a start up company in Australia I described as a “Corporate Senate”(Turnbull 1997). Its three members received no remuneration, as they had no operational executive powers and so no personal liabilities. However, if any board decision involved a conflict of interest with any director then the Senate could veto such decisions. For example: related party transactions with a dominant shareholder, the remuneration and/or re-nomination of any director or auditor or the presentation of the accounts reporting on the performance of the directors.
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A Corporate Senate provides a way for high net worth individual shareholders to directly protect their investment in a much more certain and economic manner than through proxy contests or common law remedies. Individuals can protect their interests more effectively than exposing themselves to the liabilities of becoming a director. And being a director may not protect their investment if they are out voted at a board meeting.

It is Corporate Senates, not audit committees that need to be mandated for all PTCs. The need for independent directors on boards would be eliminated and so major cost savings could be achieved to produce superior protection for PTCs of any size. Senates provide a way to eliminate many of the detailed prescriptive provisions in the law, listing rules and codes in relation to the control of auditors, related party transactions, and the independence and remuneration of directors. They would save the millions of dollars that many US corporations are now spending to comply with the Sarbanes-Oxley Act (2002) that provides inferior safeguards for the reasons discussed earlier.

To protect the property rights of large shareholders, a Senate veto can be overturned by shareholders voting on a normal plutocratic basis. However, the need to expose conflicts to public debate inhibits many excessive proposals being put forward. If a dominant shareholder used their plutocratic vote to oppress minorities then this would be reflected in the market price of the shares that would penalise the major shareholder(s) most.

Senates eliminate absolute power of directors to manage their own conflicts. A Senator would chair shareholder meetings to eliminate the conflict of directors controlling the process of being accountable. Senates provide a way for any single director to have any conflicts between the company and its dominant shareholder and/or any director reviewed by bringing it to the attention of the Senate. The Senate provides a process for having conflicts of interest reviewed discreetly without involving lawyers, outsiders, regulators or media. In this way it can provide the will for individual directors to act and also provide them the capability to act.

Some types of watchdogs, such as a Corporate Governance Board (CGB) take over the governance functions to allow directors to focus on wealth creating activities. This more robust approach was proposed in the Australian Senate by Murray (1997) and provides a superior way for governments to protect stakeholders for who they have established laws and/or regulators for prudential and/or other reasons. Another important provision in corporate constitutions to protect employees, suppliers, the public, depositors and other consumers is through the establishment of stakeholder councils as next considered.

3.2 Independently elected stakeholder Councils

It is very much in the best interest of shareholders to facilitate the establishment of stakeholder councils to provide them and their NEDs with information, independently of management to monitor both management and the business. To focus and compare the expertise, insights, knowledge and experience of disparate stakeholders, separately constituted stakeholder advisory councils would be required.

Many citizen stakeholders would have greater knowledge of the business than shareholders and perhaps even directors, especially directors who meet the various tests of being independent as by definition these are most likely to be bereft of specific knowledge and authority of the business. In addition, many stakeholders would have a greater economic interest and long term commitment to the business than many shareholders.

Unlike shareholders who discount the future value of their shares in the business from the opportunity costs of alternative investments, many citizen stakeholders would see the value of the
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business relationship with the company appreciating in the future from developing business specific experience and goodwill. In short, stakeholders may have a longer term, more knowledgeable and committed interest in the business that many shareholders. It is stakeholders rather than shareholders that have the greatest incentive, knowledge, ability and commitment to sustain corporations.

Without stakeholder councils NEDs lack a systemic process for obtaining information that can comprehensively and knowledgeably challenge the hegemony of management information. There is often two sides to any problem or opportunity and NEDs cannot carry out their fiduciary duties with due care unless they obtain views independently of management.

Each stakeholder constituency might introduce more than one different view for NEDs to consider. Stakeholder councils provide systemic processes for shareholders and NEDs to discover if their trust in management might be misplaced. Stakeholder councils also provide a way to increase efficiency by providing a formal process for consultations, Just In Time delivery and Total Quality Management.

Shareholders would need to embed in their corporate constitutions the facility for any stakeholder constituency to form its own advisory group to meet with NEDs and report directly to shareholders at AGMs. There would be minimal costs involved as stakeholders could be expected to volunteer their involvement to further their interests as demonstrated in a number of examples. The Citizen Utility Boards (CUBs) established by Ralph Nader provides an example. Customers donated funds to establish CUBs in a number of utilities to provide an opposition to management seeking price increases from regulators (Givens 1991).

Large corporations would need regional councils reporting to a peak council that would meet with NEDs say quarterly to provide feedback and feed forward information on the SWOT of management and the business independently of management. However, to provide NEDs the will to bring up proposals from stakeholders and protect the interest of minority investors against the interest of dominant interests, cumulative voting is required.

3.3 Cumulative voting

Cumulative voting secures representation on a board of NEDs who have the support of minority shareholders to further the interests of the company as whole over the interests of any dominant shareholder and/or management. Besides providing a check on domination cumulative provides the incentive and will for NEDs to privately report board conflicts to a Senate. Also raise stakeholder concerns at board meetings and/or at shareholder meetings.

With cumulative voting each share obtains as many votes as there are board vacancies. Shareholders can then allocate all or some of their votes to one or more of the candidates (Bhagat and Brickley 1984). In this way shareholders owning 20% of the shares could elect 20% of the vacancies. Cumulative voting is most effective when all board positions are voted each year.

3.4 Sunlight share trading

Corporate constitutions need to specify how shares are transferred. However, they typically fail to require the disclosure of the ultimate ownership and/or control of any of its shares so as to introduce sunlight share trading. This can be price sensitive information and without its disclosure a fair and transparent market cannot exist.
Disclosure of the controllers of ownership is required because shares can be held in discretionary trusts. The person who holds the discretion to determine who the beneficial owners can be becomes more important in determining economic interests then the nominal beneficiary.

Prior disclosure of ultimate beneficial interests is typically required for a formal take-over offer. But prior disclosure is not required when insiders trade their shares. Disclosure is only required after the share trade has been executed. This allows insiders and significant shareholders to buy or sell shares covertly. It also allows brokers and their associates to trade covertly with information not available to the public on how insiders and significant shareholders are trading.

Corporate raiders and professional investors will argue against sunlight trading because it will allow the public to follow their trades to obtain a free ride on their insights. In other words they recognise that their share trading activities represent price sensitive information. They are in effect arguing against a transparent and fair market place.

A fundamental rule in doing any business it to know with whom you are dealing. Fairness demands that the self-interest of those with superior insights be subjugated to the public interest of exposing inside traders and establishing a self-regulating market.

The cost of market monitoring by regulators would be substantially reduced with improved results by empowering all traders to become in effect co-regulators. Insiders, who traded without declaring in advance of their access to insider information to their counter party, could be discovered and sued by the counter party or regulator. The court appointed monitor of WorldCom (Breeden 2003) recommended the need for 14 days prior disclosure of any trades by insiders in the US. This is a practice that needs to be generally adopted to build trust in PTCs

4.0 Concluding remarks

No changes in corporate law are required to introduce the provisions in corporate constitutions described above to provide a compelling basis to trust PTCs. However, the universal introduction of all provisions would allow significant simplification in the law, regulations, codes and practices. It would also reduce compliance rituals, costs and bureaucracy in the private, public sectors and/or non-profit sectors.

The proposed changes would introduce “Network governance” as found in the communication and control systems of living things. For publicly traded Anglo corporations this would introduce A New Way to Govern (Turnbull 2002).

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