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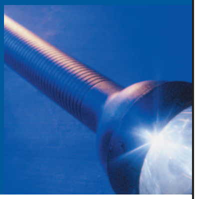

Towards real shareholder participation in contemporary corporate governance

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- *Enhanced shareholder participation in large public companies in Australia has not gone far enough*
- *Shareholders need to be given the opportunity to contribute to the forming of company decisions and strategies*
- *One proposal is to require that directors themselves be shareholders. A second proposal mandates shareholder committees in public companies*

The extent to which shareholders should be allowed to participate in the companies in which they own shares is an important issue for contemporary corporate governance.[1] In Australia, shareholder participation has recently attracted significant attention among commentators, for two reasons:

- since 1 July 2005, listed companies must now submit a remuneration report on director and senior executive pay levels to a 'non-binding' vote of shareholders at the company's AGM,[2] and
- the Federal Government's decision to abolish the '100 member rule' (allowing 100 or more shareholders to requisition an extraordinary general meeting of the company) in s 249D of the *Corporations Act 2001* (the Act), instead, reducing from 100 to 20 the number of shareholders required to bring a resolution at a company's general meeting under s 249N of the Act.[3]

Despite the current international debate on the virtues of shareholder participation,[4] for large public companies in particular, it is well-settled Australian government policy that enhancing shareholder participation is an important component of effective corporate governance reform. The government's September 2002 'CLERP 9' Discussion Paper (the impetus for which was the high-profile collapses of Ansett, HIH and One.Tel in Australia) stated that:

'The role of shareholders is recognised as critical for good corporate governance practice. Shareholders do not assume responsibility for day-to-day management of a corporation. However, they can influence the behaviour of the corporation over the longer term through exercising influence on fundamental matters. ...'

The OECD *Principles of Corporate Governance* have widespread acceptance as a framework for good corporate governance practices. The first of those principles refers to basic shareholder rights to participate effectively and vote in general meetings. In particular, these basic shareholder rights are mentioned as a key component of a good corporate governance framework.

CLERP 9 reforms

In the 'CLERP 9' Discussion Paper, the government proposed initiatives to improve communication with shareholders, and to encourage their active involvement in company meetings. The CLERP 9 Act (the *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004* (Cth)) eventually came into force on 1 July 2004, and implemented a number of important amendments to the Act, which are designed to facilitate and promote the exercise by shareholders of important governance rights (being informed of company activities, as well as to participate in and to vote at general meetings of the company).[5]

The key amendments in this area are designed to:

- encourage companies to embrace technology (particularly the internet and email) and forms of electronic communication (such as web casting) to improve communication with shareholders, particularly facilitating the distribution of notices of meeting and annual reports through electronic means,[6]

- encourage shorter and more comprehensible notices of company meetings so that shareholders can fully understand the contents of the notices (see s 249L(3) which introduced a requirement that notices are worded and presented in a 'clear, concise and effective manner')
- improve shareholder access to general meetings by facilitating proxy voting (in particular, electronic proxy voting by permitting regulations to prescribe mechanisms which authenticate proxy appointments provided electronically[7]), and
- make shareholders better informed by requiring listed company directors to disclose other directorships held in the three years prior to the end of the financial year to which the report relates,[8] and requiring that the qualifications and experience of the company secretary be included in the directors' report.[9]

> ... the reforms and initiatives directed at shareholder participation do not enable shareholders to actually participate in the formulation of decisions and strategies of the corporation — something that we believe is necessary for real shareholder participation.

In addition, the CLERP 9 Act introduced a new requirement under the Act for listed companies to include a so-called 'Management Discussion and Analysis (MD&A)' review in their annual report. This review must include sufficient information to enable shareholders to make an informed assessment of the entity's operations, financial position and business strategies and its future prospects.[10] This idea is built on existing ASX Listing Rule 4.10.17, requiring an ASX-listed company's annual report to include a review of operations and activities.

ASX Corporate Governance Council principles

Preceding the implementation of the CLERP 9 reforms was the release of the ASX Corporate Governance Council's *Principles of Good Corporate Governance and Best Practice Recommendations*, which outlined 10 principles of good corporate governance, and 28 recommendations for achieving good corporate governance practices (which listed companies must adhere to, or otherwise explain their departure from one or more of the recommendations).[11]

Principle 6 of the ASX guidelines is: *'Respect the rights of shareholders and facilitate the effective exercise of those rights'*. It is recommended that, to adequately respect the rights of shareholders, listed companies should design and disclose a communications strategy to promote effective communication with shareholders, and encourage effective participation at general meetings. This should include how best to take advantage, wherever practicable, of new technologies to improve shareholder participation, and enhance market awareness of company information through electronic means.

Further, it is recommended that listed companies should use general meetings effectively to communicate with shareholders and allow reasonable opportunity for informed participation.[12] The ASX Corporate Governance Council has prepared guidelines to help companies improve shareholder participation through the design and content of notices, and through the conduct of the company's meeting.[13]

So as you can see, some significant initiatives have been implemented over the past few years to try to ensure that shareholder participation is a central component of a company's governance arrangements. Despite this, what can also be seen when considering the above initiatives is that lawmakers and regulators have only been prepared to go so far in facilitating shareholder participation.

Do these reforms go far enough?

In fact, in our view, while the reforms are intended to significantly empower shareholders, they effectively do no such thing. Generally speaking, the reforms and initiatives directed at shareholder participation merely provide for shareholders to be better informed about the decisions and activities engaged in by the company, and provide shareholders with greater opportunity to be able to participate in the annual general meetings and exercise their veto rights over decisions requiring the endorsement of shareholders. *They do not go beyond that and enable shareholders to actually participate in the formulation of decisions and strategies of the corporation* — something that we believe is necessary for real shareholder participation.[14]

According to the *New Oxford Dictionary of English*, 'participant' is defined as 'a person who takes part in something' with the example given that 'staff are to be active participants in the decision-making process'. It then goes on to provide that the Latin translation of 'participant' is 'sharing in'.[15] This reinforces that real participation by shareholders is not achieved simply by informing shareholders of decisions that are made, and empowering shareholders to veto decisions at the annual general meeting. Under this approach, shareholders are not participants in the actual decision-making process. Shareholder corporate governance rights really only kick in after the decisions of the company have already been made.

Shareholders can exercise voting rights at the general meeting in an attempt to veto a decision and, hence, this could be considered to be participating at least in some way in the decision-making process. In reality, however, individual shareholders in public listed companies very rarely have the voting power or influence to veto decisions or even to have any input into how the decision is formed.

While reverting back to the dictionary definition of 'participate' might be dismissed by some as mere semantics, it does help to reinforce the argument that the so-called shareholder participation movement is not promoting 'participation' in the real sense of the word. In our book, *Principles of Contemporary Corporate Governance* (Cambridge University Press, 2005) we outline two central proposals for reform to achieve real shareholder participation in contemporary corporate governance.

The first proposal is a pragmatic one, recommending that directors should be required to be equity stakeholders in the company.[16] That is, if our thesis is that real shareholder participation entails actually participation in the formulation of decisions and strategies of the corporation, let's make the individuals already involved in this formulation process, shareholders. The second proposal is that a shareholder committee should be embedded in the governance structure of all public companies to provide a vehicle through which shareholders can have input into the activities of such companies.[17]

Proposal that directors be shareholders in the company

The normal response of academics and other commentators to the perceived problem of shareholder passivity in the large modern corporation is to strengthen the rights and remedies of shareholders, as a means of protecting them from the tyranny of the board and majority shareholders. Rarely do commentators, particularly in Australia, put forward the idea of shareholder and director 'alignment'[18], that is, directors also being made shareholders in the company.[19]

A common feature of corporate governance reform packages in Australia (ASX Corporate Governance Council recommendations), the United Kingdom (the Combined Code) and the United States (the *Sarbanes-Oxley Act* 2002 and NYSE Listing Rules) is a preference for 'independent' directors. While the meaning of 'independence' in this context is not without some degree of uncertainty, in Australia at least one requirement for 'independence' is that directors must not be substantial shareholders of the company.[20] What is meant by 'substantial' is not discussed in the guidelines but is rather a judgment left to the board.

In this respect, it is assumed that lack of such independence is undesirable. This is reflected by the fact that directors must establish, and justify in the annual report and to shareholders, that holding beyond a certain amount of shares does not jeopardise the characterisation of directors as being independent, and does not (at least doctrinally) place a barrier between shareholding and directorship. So while shareholding is not ruled out for directors, their right to hold shares is significantly curtailed. This might be considered to provide an impenetrable barrier to our proposal being implemented.

There is, however, a significant degree of normative and theoretical literature which suggests that the drive to having more independent directors is misguided, and that requiring directors to be shareholders (even significant shareholders) in the company may not be such a bad thing at all. As we point out in our book, it is suggested that one of the fundamental causes for the poor financial decisions of many company directors may indeed be that they are spending somebody else's money, and they are not personally liable for the losses if their decisions were based on poor business judgments. Thus, a key to better corporate management may lie in a closer alignment between the interests of the shareholders and directors — to the maximum extent possible, their fortunes should rise and fall together. This would reduce the degree of reckless spending decisions by directors, and at the same time guarantee (as a natural result) a closer relationship between the interests of directors and shareholders.

This is a point not missed (but ultimately not endorsed) by Justice Neville Owen in his 2003 Report into the high-profile collapse of HIH Insurance. Justice Owen notes:

> … it is not immediately clear to me why a substantial shareholding in the company should be regarded as compromising independence. Such a shareholding may provide greater incentive to bring the interests of the company to bear. On the other hand, the fact that a director has a close personal association with the chief executive may be destructive of independence, but is very difficult to assess objectively or on a 'check-list'

> basis. The critical question, it seems to me, is not so much whether, on objective criteria, the individual is 'independent' but rather whether he or she is subjectively capable of exercising independent judgment (emphasis added).[21]

There is also quite a sizeable amount of empirical evidence, both in Australia and overseas, against the proposition that companies with a wide and diverse shareholder body and a boardroom full of independent directors perform better. For example, University of Cambridge law professor Brian Cheffins has observed that:

> There is no meaningful correlation between ownership structure and corporate performance. … [I]t cannot be taken for granted that the widely held professionally managed firm will yield superior economic outcomes.[22]

According to Cheffins, while many large US companies with a strong separation of ownership and control have been tremendously successful, there is empirical evidence that large companies in European countries where ownership is more closely held (indeed, ownership commonly remains in the family) have been just as successful, if not more successful, than their US counterparts.[23]

Similarly, as to the evidence in Australian companies, Fred Hilmer and Lex Donaldson note that:

> The first assumption of the independent director dogma is that boards made up predominantly of independent outside directors produce better results than boards made up predominantly of managers. Researchers have examined companies to see whether this is true. The results are fascinating. Most studies fail to find that outsider-dominated boards are associated with more profitable companies. On the contrary, most studies find that outsider-dominated boards produce poorer company performance and that insider-dominated boards are superior. These results are meaningful because most researchers start out expecting to prove that outside boards are superior. A majority of managers on a board may reduce its independence. However, this is offset by the insider board's far greater expertise in the company's business, leading to higher performance than under the outside board.[24]

Although we do not deny that there is a definite place in the complete corporate governance picture for independent non-executive directors, it is 'barking up the wrong tree' to over-emphasise their role and effectiveness. Time, energy and money will, in our view, be better spent to adopt an open-minded and inclusive approach to corporate governance (see our definition of corporate governance in Chapter 1 of *Principles of Contemporary Corporate Governance*) rather than adopting a narrow approach and focusing only on selected areas of corporate governance like the financial aspects of corporate governance or the role and effectiveness of independent non-executive directors.

Proposal to set up a shareholder committee

As we note in our book, however, this first proposal to require that directors be made shareholders in the company does not directly and demonstrably advance the interests of the smaller shareholder who does not have capacity or inclination to become a director. We therefore propose that a method by which their interests and concerns can be accommodated within the corporate setting is to embed a 'shareholder committee' within the governance structure of public companies. This would give all shareholders a forum through which their views could be directly fed into the corporate decision-making process.

There are a number of advantages associated with such a proposal. Some of these are highlighted by US law professor Edward B Rock, who argues that grouping shareholders together through a shareholder committee, and providing the shareholder committee with a clear role within the governance structure of the company alongside the board and management, is the best way to increase the rationality (rather than continuing the irrationality) of shareholder action within public companies.[25]

The shareholder committee within companies should be comprised of a minimum of five and a maximum of seven members, to be automatically rotated every three years (to avoid any suggestion of members of the committee becoming too close to the board of directors). One member of the committee would be chosen from the board of directors, and one would be from a 'professional panel' (an appointed lawyer, accountant, investment banker etc).

The committee would have mainly an advisory role, acting as a conduit between shareholders and management with a view to enhancing shareholder participation and representation within the company, rather than disrupting the day-to-day management and oversight of the company. The committee would also be the first port-of-call for shareholder grievances, and would perform the function of internal review. Shareholders who are dissatisfied with particular aspects of the company's commercial behaviour, or believe that the company or the company's directors and similar officers have engaged in a breach of the Act, could petition the committee to hear the dispute and try and reach a commercial outcome (within a limited time frame, such as one week from the time of application) which is satisfactory to all parties. This would overcome the present sense of shareholder apathy and disenfranchisement as shareholders would be able to have their disputes heard promptly and informally.

The key role of the proposed committee, however, would be to discuss and formulate initiatives and policies to not only enhance communication with shareholders in the short-to-medium term, but also encourage the board and management to implement strategies which make shareholder communication a central aspect of a company's corporate governance practices for the long term.

It is anticipated that the approach of the shareholder committee will be very much policy-oriented, with new issues and developments occurring from time to time which will require a considered committee response, with a view to facilitating improved communication between shareholders and the board, and enhancing shareholder participation and representation. As new issues emerge which potentially impact on shareholder communication, it would be expected that a company's shareholder committee, particularly in the larger companies, would play an important role in the development of the law and reform proposals through formulating submissions, and developing initiatives to be implemented within the company, which can then be adopted more broadly by companies.

Regarding the powers of such a shareholder committee, it is proposed that the committee would have some role in the nomination of directors, and perhaps some rule in setting (or at least commenting throughout the development of) compensation arrangements for senior executives in the company. At the very least, companies would be required to consult the shareholder committee on director nominations for a particular year, and on any significant payments to the company's executives.

Conclusion

It is important to emphasise that both proposals made in this article are centred on challenging the widely held view that the division between 'ownership' (shareholders) and 'control' (directors and executives) in the corporate setting is desirable, particularly in large public companies. The government's support for shareholder participation as a mechanism for achieving good governance practices is significant, but more needs to be done than just improve communication between the company and its shareholders. This does not provide for shareholder participation in the real sense of the word. Shareholders can 'lie on the couch' and receive company announcements in the mail day after day, and still feel removed from the actual inner hub or workings of the company. This is why we need to make a concerted effort to substantially reduce the separation of ownership and control in public companies, so that shareholders that wish to 'get off the couch' and play a useful role in the company are given an avenue to do so.

The authors have written a new book, Principles of Contemporary Corporate Governance, *published by Cambridge University Press, 2005.*

Notes

1 See generally J J du Plessis, J McConvill and M Bagaric, *Principles of Contemporary Corporate Governance* (2005) Ch 13; J McConvill, *Shareholder Participation in the Corporation: A New Perspective* (2005).

2 This is provided for in s 250R(2) and (3) of the *Corporations Act 2001* (the Act). See Geoffrey Newman, 'Execs Big Bucks to Go', *The Australian*, 5 August 2005. Newman discusses that while the vote is non-binding, there are expectations that a negative vote by the shareholders will have a significant persuasive effect.

3 See Corporations Amendment Bill (No 2) (2005), presented in draft form for public consultation in February 2005.

4 See J McConvill, above n 1; in support of strong shareholder participation, see L Bebchuk, 'The Case for Increasing Shareholder Power' (2005) 118 *Harvard Law Review* 839, J Velasco, 'The Fundamental Rights of the Shareholder Rights', Notre Dame Law School Working Paper, August 2005 (available online at <www.ssrn.com>), L Bebchuk, 'Why Firms Adopt Anti-takeover Arrangements' (2003) 152 *University of Pennsylvania Law Review* 713; for commentary questioning the place of shareholder participation in contemporary corporate governance, see SM Bainbridge, 'The Case for Limited Shareholder Voting Rights' (2005) *UCLA Law Review* (forthcoming); HG Hutchinson, 'Director Primacy and Corporate Governance: Shareholder Voting Rights Captured by the Accountability/Authority Paradigm' (2005) 36 *Loyola University of Chicago Law Journal* 1111; SM Bainbridge, 'Executive Compensation: Who Decides' (2005) 83 *Texas Law Review* 1615; L Stout, 'The Shareholder as Ulysses: Some Empirical Evidence on Why Investors in Public Companies Tolerate Board Governance' (2003) 152 *University of Pennsylvania Law Review* 667, 672: 'Just as Ulysses in legend sought to serve his own interests by binding himself to the mast of the ship, investors may be seeking to serve their own interests by binding themselves to boards.'

5 See J McConvill, *An Introduction to CLERP 9* (2004) Ch 11.

6 See ss 249J and 314 of the Act.

7 See s 250A(1A) of the Act and reg 2G.2.01 of the Corporations Regulations.

8 See s 300(11)(e) of the Act.

9 See s 300(10)(d) of the Act.

10 See s 299A of the Act.

11 See JJ du Plessis, J McConvill and M Bagaric, above n 1, Ch 9.

12 ASX Corporate Governance Council, *Principles of Good Corporate Governance and Best Practice Recommendations*, March 2003, Recommendation 6.1.

13 Ibid, Attachment A 'Guidelines for Notices of Meetings'.

14 See J McConvill, 'Piercing the Decision-Making Sphere: Happiness as the Key to Real Shareholder Participation' (2005) 16 *European Business Law Review* 831.

15 *New Oxford Dictionary of English* (2001 edition) 1352.

16 This proposal is explained in more detail in J McConvill and M Bagaric, 'Why all Directors Should be Shareholders in the Company: the Case Against "Independence"' (2004) 16 *Bond Law Review* 40.

17 For a detailed explanation of this proposal, see J McConvill and M Bagaric, 'Towards Mandatory Shareholder Committees in Australian Companies' (2004) 28 *Melbourne University Law Review* 125.

18 According to CB Carter and JW Lorsch, *Back to the Drawing Board* (2004) 47, the alignment argument was introduced in the 1980s, and contends that the director's job is to provide the best possible return to shareholders, and will do a better job if they think and act like shareholders. Therefore, directors should own stock, and non-executive directors should be paid wholly or partially in stock and/or options. Carter and Lorsch go on to discuss that while the 'alignment' concept was initially met with resistance in countries outside the US, due to the growing use of stock options as an integral part of corporate governance practices, things are changing. See also GP Baker, MC Jensen and KJ Murphy, 'Compensation and Incentives: Practice versus Theory' (1988) 43(3) *Journal of Finance* 593; MC Jensen and KJ Murphy, 'Performance Pay and Top Management Incentives' (1990) 98(2) *Journal of Political Economy* 225.

19 See, for example, F Hilmer and L Donaldson, *Management Redeemed* (1996), reproduced as Appendix 1 in F Hilmer, *Strictly Boardroom: Improving Governance to Enhance Company Performance* (2nd ed, 1998), 62: 'A preferable way [to create a financial incentive] may be an arrangement which gives the manager bonuses either annually or on a deferred basis in step with increases in share value'. For US analysis, see MC Jensen, 'The Modern Industrial Revolution, Exit and the Failure of Internal Control Systems' (1994) 6(4) *Journal of Applied Corporate Governance* 4, 19 ('much of America's governance problems arise from the fact that neither management nor board members typically own substantial fractions of their firm's equity').

20 See J McConvill, above n 5, Appendix 1 for a comparative list of recent corporate governance reforms in Australia, the United Kingdom and the United States.

21 Final Report of the HIH Royal Commission ('HIH Report'), available online at <http://www.hihroyalcom.gov.au/finalreport/Front%20Matter,%20critical%20assessment%20and%20summary.HTML>, 6.2.

22 B Cheffins, 'Corporate Law and Ownership Structure - A Darwinian Link?' (2002) 25 *University of New South Wales Law Journal* 346, 357.

23 See B Cheffins, *Ibid*. For counter arguments, see J Coffee, 'The Rise of Dispersed Ownership: The Roles of Law and State in the Separation of Ownership and Control' (2001) 11 *Yale Law Journal* 1.

24 F Hilmer and L Donaldson, *Management Redeemed* (1996), reproduced as Appendix 1 in F Hilmer, *Strictly Boardroom: Improving Governance to Enhance Company Performance* (2nd ed, 1998).

25 See EB Rock, 'The Logic and (Uncertain) Significance of Institutional Shareholder Activism' (1991) 79 *Georgetown Law Journal* 445.